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Unbundling Procedure: Carve-Outs From Arbitration Clauses

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UNBUNDLING PROCEDURE: CARVE-OUTS FROM ARBITRATION CLAUSES

Christopher R. Drahozal^{*}

Erin O'Hara O'Connor^{**}

Abstract

A rich literature analyzes how parties choose between courts and arbitration. Within this literature, scholars traditionally assume that sophisticated parties make a single choice between courts and arbitration based on the bundle of dispute resolution services that seems most appealing *ex ante*. As with the literature on bundling generally, however, legal scholars are increasingly focusing their attention on the unbundling of court and arbitral procedures—that is, the ability of parties to contract for à la carte or customized dispute resolution procedures in court and arbitration. While such unbundling is common *ex post*, i.e., after a dispute arises, most of the scholarly attention has focused on *ex ante* unbundling of procedures. Unfortunately, this burgeoning theoretical literature faces a difficult empirical reality: the available empirical evidence reveals surprisingly little use of customized procedural rules in contracts between sophisticated parties. Parties appear only rarely to agree to unbundle dispute resolution procedures *ex ante*.

This Article argues that *ex ante* procedural unbundling does occur, but through unbundling by claim and remedy rather than through à la carte choice of individual procedures. In a wide variety of contracts, parties routinely unbundle the procedures governing their anticipated disputes, deciding to pursue some claims and remedies in court and others in arbitration. By unbundling claims and remedies in this manner, parties can obtain greater performance incentives and lower dispute resolution costs without facing the prospect of prohibitively expensive specification costs. Claim and remedy unbundling, through contractual carve-outs and carve-

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ins, enables parties to separate governing procedures based on the nature of the specific risks of nonperformance. For most parties, less perfectly crafted off-the-rack rules applied on the basis of carefully tailored claims appear preferable to more carefully tailored procedural rules that must then apply to all possible disputes.

The prevalence of unbundling by carve-outs in contracts involving sophisticated parties has policy implications for courts' treatment of unconscionability and nonarbitrability questions that arise in the context of enforcing arbitration clauses. Moreover, to ensure that local courts provide value to commercial parties, governments should focus on the substantive rules and procedures applied to claims that function to protect information, innovation, reputation, and property.

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INTRODUCTION

Bundling, or the package sale of two or more goods or services, is “ubiquitous.”¹ Consider, for example, gift baskets, cable service packages, and cars sold with standard options.² This widespread bundling suggests that firms and customers both benefit from packaged products and services.³ At the same time, however, recent technological innovation and legal change have resulted in increasing unbundling of previously packaged products. Phone companies provide long distance calling plans separately from local phone service.⁴ Airlines charge separately for air travel and baggage handling.⁵ Music companies sell songs individually instead of in albums.⁶ Television programs are available à la carte.⁷ Economists and others debate the implications of unbundling for consumers and society,⁸ but it is undisputed that unbundling is occurring.

Like other sellers, courts and arbitration institutions provide bundles of services to their customers—in this case, bundles of dispute resolution procedures to the parties in a dispute. Courts provide the default bundle,⁹ but parties can opt instead for arbitral procedural bundles that vary according to the applicable arbitration rules chosen by the parties.¹⁰ The

1. See Bruce H. Kobayashi, *Does Economics Provide a Reliable Guide to Regulating Commodity Bundling by Firms? A Survey of the Economic Literature*, 1 J. COMPETITION L. & ECON. 707, 707–08 (2005).

2. For other examples, see *id.* at 708 n.2.

3. Bruce H. Kobayashi, *Two Tales of Bundling: Implications for the Application of Antitrust Law to Bundled Discounts*, in ANTITRUST POLICY AND VERTICAL RESTRAINTS 10, 10–12 (Robert W. Hahn ed., 2006). Kobayashi also describes potential price discrimination and anti-competitive uses of bundling. *Id.* at 14–22.

4. See Nicholas Economides et al., *Quantifying the Benefits of Entry into Local Phone Service*, 39 RAND J. ECON. 699, 699 (2008).

5. Hans O. Schumann & Harmeet Singh, *The De-Bundling of U.S. Airline Bag Fees and Fares: An Exploratory Study*, 13 J. ACAD. BUS. & ECON. 91, 91 (2013).

6. Anita Elberse, *Bye-Bye Bundles: The Unbundling of Music in Digital Channels*, 74 J. MARKETING 107, 107 (2010).

7. See Gregory S. Crawford & Ali Yurukoglu, *The Welfare Effects of Bundling in Multichannel Television Markets*, 102 AM. ECON. REV. 643, 682–83 (2012).

8. E.g., Guy A. Rub, *Contracting Around Copyright: The Uneasy Case for Unbundling of Rights in Creative Works*, 78 U. CHI. L. REV. 257 (2011) (analyzing the efficiency of contracts that unbundle the rights created by copyright law); Gad Allon et al., *Would the Social Planner Let Bags Fly Free?* (Aug. 30, 2011) (working paper), available at <http://papers.ssrn.com/abstract=1919807> (modeling reasons for unbundling air travel and baggage transportation); Marty Lariviere, *Are Baggage Fees Good for Society?*, THE OPERATIONS ROOM (Aug. 31, 2011), <http://operationsroom.wordpress.com/2011/08/31/are-baggage-fees-good-for-society/> (discussing Allon et al., *supra*).

9. See STEPHEN J. WARE, ALTERNATIVE DISPUTE RESOLUTION § 1.5 (2d ed. 2007) (stating that “litigation is the default process of dispute resolution”).

10. For examples of off-the-rack procedural rules, see INT’L CHAMBER OF COMMERCE, ARBITRATION RULES (2012), available at <http://www.iccwbo.org/Products-and-Services/Arbitration-and-ADR/Arbitration/Rules-of-arbitration/Download-ICC-Rules-of-Arbitration/ICC-Rules-of-Arbitration-in-several-languages/> [hereinafter ICC ARBITRATION RULES]; AM. ARBITRATION ASS’N, COMMERCIAL ARBITRATION RULES AND MEDIATION PROCEDURES (2013), available at

choice between courts and arbitration depends on a number of factors. Courts provide government-appointed decision makers (i.e., judges), typically provide more discovery than arbitration, and include an appeals process.¹¹ In contrast, arbitration provides party-selected decision makers (i.e., arbitrators), generally provides less discovery than court, often generates a more expedited final determination, and offers only a limited appeals process.¹² Courts are open to the public (with exceptions) and subsidized by the government; arbitration is typically confidential and is paid for by the parties.¹³ Class actions may be available in court, but are unavailable in arbitration (at least when parties include a class arbitration waiver with their arbitration clause).¹⁴

A rich collection of literature analyzes party choice between courts and arbitration.¹⁵ Within this literature, scholars traditionally assume that sophisticated parties make a single choice between courts and arbitration based on the bundle of dispute resolution services that seem most appealing *ex ante*.¹⁶ As with the literature on bundling generally, however, legal scholars are increasingly focusing their attention on the unbundling of court and arbitral procedures—that is, the ability of parties to contract for a

https://www.adr.org/aaa/ShowProperty?nodeId=/UCM/ADRSTG_004103 [hereinafter AAA COMMERCIAL ARBITRATION RULES]; JAMS EMPLOYMENT ARBITRATION RULES & PROCEDURES (2009), available at <http://www.jamsadr.com/rules-employment-arbitration/>.

11. See, e.g., Stephen A. Broome, *An Unconscionable Application of the Unconscionability Doctrine: How the California Courts Are Circumventing the Federal Arbitration Act*, 3 HASTINGS BUS. L.J. 39, 42–44 (2006); see also Kevin M. Lemley, *I'll Make Him an Offer He Can't Refuse: A Proposed Model for Alternative Dispute Resolution in Intellectual Property Disputes*, 37 AKRON L. REV. 287, 310–12 (2004) (discussing the advantages and risks of litigation).

12. See, e.g., Christopher R. Drahozal & Quentin R. Wittrock, *Franchising, Arbitration, and the Future of the Class Action*, 3 ENTREPRENEURIAL BUS. L.J. 275, 300 (2009) (“A party including an arbitration clause in its contract is specifying a bundle of characteristics of the dispute resolution process.”); Obiajulu Charles Okuh, *Reasons to Arbitrate Disputes Between Multinational Companies and Third-Country National Employees*, DISP. RESOL. J. May/July 2011, at 64, 70–71

13. See Amy J. Schmitz, *Untangling the Privacy Paradox in Arbitration*, 54 U. KAN. L. REV. 1211, 1222–26 (2006); Stephen J. Ware, *The Case for Enforcing Adhesive Arbitration Agreements—with Particular Consideration of Class Actions and Arbitration Fees*, 5 J. AM. ARB. 251, 285 (2006).

14. See Myriam Gilles, *Opting Out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action*, 104 MICH. L. REV. 373, 377 (2005).

15. For examples, see Bruce L. Benson, *To Arbitrate or To Litigate: That is the Question*, 8 EUR. J.L. & ECON. 91 (1999); Christopher R. Drahozal & Keith N. Hylton, *The Economics of Litigation and Arbitration: An Application to Franchise Contracts*, 32 J. LEGAL STUD. 549 (2003); Keith N. Hylton, *Agreements to Waive or to Arbitrate Legal Claims: An Economic Analysis*, 8 SUP. CT. ECON. REV. 209 (2000); William M. Landes & Richard A. Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUD. 235 (1979); Steven Shavell, *Alternative Dispute Resolution: An Economic Analysis*, 24 J. LEGAL STUD. 1 (1995); see also 1 GARY B. BORN, INTERNATIONAL COMMERCIAL ARBITRATION 70–90 (2009); CHRISTIAN BÜHRING-UHLE, ARBITRATION AND MEDIATION IN INTERNATIONAL BUSINESS 127–56 (1996); Christopher R. Drahozal & Stephen J. Ware, *Why Do Businesses Use (or Not Use) Arbitration Clauses?*, 25 OHIO ST. J. ON DISP. RESOL. 433 (2010).

16. See *infra* text accompanying note 29.

la carte or customized dispute resolution procedures in court and arbitration.¹⁷ While such unbundling is common *ex post*, i.e., after a dispute arises,¹⁸ most of the scholarly attention has focused on *ex ante* unbundling of procedures.¹⁹ Unfortunately, this burgeoning theoretical literature faces a difficult empirical reality: the available empirical evidence reveals surprisingly little use of customized procedural rules in contracts between sophisticated parties.²⁰ Parties appear only rarely to agree to unbundle dispute resolution procedures *ex ante*.

This Article argues that *ex ante* procedural unbundling does occur, but through unbundling by claim and remedy rather than through à la carte choice of individual procedures. Although procedural scholars have ignored claim and remedy unbundling, it plays a vital role in contractual customization of dispute resolution. Specifically, parties that agree to

17. For examples, see Robert G. Bone, *Party Rulemaking: Making Procedural Rules Through Party Choice*, 90 TEX. L. REV. 1329 (2012); Kevin E. Davis & Helen Hershkoff, *Contracting for Procedure*, 53 WM. & MARY L. REV. 507 (2011); Jamie Dodge, *The Limits of Procedural Private Ordering*, 97 VA. L. REV. 723 (2011); Daphna Kapeliuk & Alon Klement, *Changing the Litigation Game: An Ex Ante Perspective on Contractualized Procedures*, 91 TEX. L. REV. 1475 (2013); Michael L. Moffitt, *Customized Litigation: The Case for Making Civil Procedure Negotiable*, 75 GEO. WASH. L. REV. 461 (2007); Henry S. Noyes, *If You (Re)Build It, They Will Come: Contracts to Remake the Rules of Litigation in Arbitration's Image*, 30 HARV. J.L. & PUB. POL'Y 579 (2007); Colter L. Paulson, *Evaluating Contracts for Customized Litigation by the Norms Underlying Civil Procedure*, 45 ARIZ. ST. L.J. 471 (2013); Robert J. Rhee, *Toward Procedural Optionality: Private Ordering of Public Adjudication*, 84 N.Y.U. L. REV. 514 (2009); Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814 (2006); Elizabeth Thornburg, *Designer Trials*, 2006 J. DISP. RESOL. 181.

18. See, e.g., Moffitt, *supra* note 17, at 495–96; Judith Resnik, *Procedure as Contract*, 80 NOTRE DAME L. REV. 593, 600 (2005). This Article focuses primarily on *ex ante* unbundling via the use of carve-outs from arbitration for two reasons. First, *ex ante* carve-outs are more easily and more reliably studied than are *ex post* carve-outs. Second, where drafting costs can be overcome, *ex ante* customization likely is more frequent than *ex post* customization, at least in the context of arbitration. As several scholars have noted, *ex post*, the parties' interests likely diverge in ways that make agreement over large matters difficult. See, e.g., Scott Baker, *A Risk-Based Approach to Mandatory Arbitration*, 83 OR. L. REV. 861, 895–96 (2004); Christopher R. Drahozal, "Unfair" Arbitration Clauses, 2001 U. ILL. L. REV. 695, 746–78; Samuel Estreicher, *Saturns for Rickshaws: The Stakes in the Debate over Predispute Employment Arbitration Agreements*, 16 OHIO ST. J. ON DISP. RESOL. 559, 567–68 (2001). Although this Article focuses on studies of *ex ante* customization, the possibility of limited *ex post* customization could cause parties to avoid the drafting costs of *ex ante* procedural customization, a topic that Part I briefly discusses. Finally, this Article focuses on carve-outs rather than carve-ins because carve-outs appear to be much more commonly incorporated into party agreements. In the contracts we studied, evidence of carve-ins was much more isolated.

19. See, e.g., Resnik, *supra* note 18.

20. David A. Hoffman, *Whither Bespoke Procedure?*, 2014 U. ILL. L. REV. 389, 429 (2014) ("There is precious little evidence that parties are routinely, or even rarely, attempting to tailor public procedure [i.e., procedures in court] to their own ends."); Erin O'Hara O'Connor et al., *Customizing Employment Arbitration*, 98 IOWA L. REV. 133, 137 (2012) ("[D]espite the robust academic literature on the subject, real-world customization is largely absent, although we find some evidence that it is slowly increasing over time.").

arbitration clauses commonly exclude (or carve out) certain claims or remedies from their arbitration clause,²¹ and parties that plan to take most disputes to court sometimes provide for arbitration to resolve particular matters. In separate studies, the authors found considerable evidence that these forms of customization are common. O'Hara O'Connor et al. found "strong evidence" of parties to CEO employment contracts "carving out certain types of litigable claims from otherwise broad agreements to arbitrate."²² Likewise, Drahozal and Wittrock found that arbitration clauses in franchise agreements frequently contained carve-outs.²³ Less commonly, according to the CEO employment data studied by O'Hara O'Connor, parties will agree to litigate future disputes as a matter of default but then agree to resolve certain specific disputes through arbitration. In these latter situations, the parties "carve in" particular matters to arbitration.

Carve-outs and carve-ins are mechanisms by which parties choose between court and arbitral bundles of procedures on a claim-by-claim or remedy-by-remedy basis. By using carve-outs and carve-ins, parties can obtain a more carefully calibrated unbundling of procedure than an arbitration clause or forum-selection clause alone would provide, but at a much lower overall cost than the parties would incur by contracting for individual procedures. What often results is a sort of middle ground for bundling of procedural rules: parties choose among pre-set bundles of dispute resolution services, but unbundle the circumstances where any given dispute resolution bundle will be used. This phenomenon is common and widespread, observed with varying frequency across a number of different contracting contexts, and thus deserves more careful consideration.

This Article theoretically and empirically analyzes procedural unbundling by use of carve-ins and carve-outs.²⁴ Part I provides an informal model of decision-making regarding the choice between court and arbitral procedural bundles as well as the unbundling of those procedures by use of carve-outs and individualized customization. Under the model, choices regarding dispute resolution forum and possible unbundling are a function of performance incentives, dispute resolution costs, drafting (or specification) costs, and bifurcation costs resulting from the possibility that a dispute between the parties might need to be resolved in two different

21. Even outside the context of customized procedure, carve-outs have received relatively little discussion in the academic literature. For exceptions, see Christopher R. Drahozal, *Nonmutual Agreements to Arbitrate*, 27 J. CORP. L. 537, 552–55 (2002); Stephen J. Ware, *Paying the Price of Process: Judicial Regulation of Consumer Arbitration Agreements*, 2001 J. DISP. RESOL. 89, 97–99.

22. O'Hara O'Connor et al., *supra* note 20, at 137.

23. Christopher R. Drahozal & Quentin R. Wittrock, *Is There a Flight from Arbitration?*, 37 HOFSTRA L. REV. 71, 113–15, 114 tbl.16 (2008).

24. Specifically, the Article treats the two phenomena theoretically, but reports on carve-outs only in the empirical analysis, due to the fact that carve-outs appeared much more frequently than did carve-ins in our studies.

forums. The model sheds light on why some, but not all, parties will opt for carve-outs or carve-ins, and why à la carte, customized procedure could prove too costly for most parties.

Part II empirically analyzes procedural unbundling by carve-outs in several contractual settings, including CEO employment contracts, technology agreements, franchise contracts, joint-venture agreements, and cell phone service contracts. These different contractual settings enable a comparison of the use of carve-outs across varying types of relationships; in domestic, foreign, and cross-border contracts; and in sophisticated party and consumer settings.

Part III explores several implications of procedural unbundling by carve-outs for future scholarship and public policy. First, carve-outs are a form of procedural unbundling that deserves greater emphasis in the literature on contractual procedure. When understood as procedural unbundling, carve-outs shed light on the plausibility of explanations for the dearth of other types of contractual customization.

Second, in the literature on economic development, scholars disagree about the extent to which a nation seeking to maximize investment opportunities needs first-rate court systems with highly developed rule-of-law principles when it could instead opt for the cheaper route of credibly committing to enforce arbitration clauses and awards. Our study of procedural unbundling by use of carve-outs suggests that arbitration is not always a perfect substitute for well functioning courts. Instead, the governing legal principles and court procedures are far more important for the resolution of some types of private disputes than others. This Article examines some more general implications as well. For example, it suggests that states look more closely at their rules governing specific performance as a remedy.

Third, the common use of carve-outs by sophisticated parties provides important context for courts when reviewing the use of carve-outs in contracts with consumers and employees. Courts around the world are currently struggling with whether to enforce contract clauses that give only one party a right to seek relief in courts or in arbitration; this Article's analysis provides helpful guidance for some of those cases. Courts often see carve-outs as strange contract terms that likely lack legitimate business justification, but this suspicion is unwarranted. Far from shocking the conscience, these provisions are common in contracts between sophisticated parties who are represented by lawyers. Such provisions are not inherently unfair exercises in nonmutuality; instead, at least in sophisticated party contracts, they are wealth-maximizing customizations that provide value to the parties.

Finally, this Article's analysis of procedural unbundling by carve-outs suggests that courts should be more willing to use severability doctrines to preserve the arbitration obligation for remaining claims, even when some

claims must proceed in court. Contrary to the assumptions used by most courts, sophisticated parties readily contract for proceedings bifurcated between arbitration and court. Accordingly, when a court invalidates certain provisions in an arbitration clause as unconscionable, it should preserve the remainder of the arbitration clause for claims as to which the arbitral procedural bundle is not unconscionable. Our analysis suggests that courts currently may be too willing to strike the entire arbitration provision. Likewise, this analysis supports the conclusion that when Congress or a court decides that a federal right is not appropriately vindicated in arbitration, the limitation should extend only to the problematic claim, rather than striking the entire arbitration clause, as sometimes happens. Part III uses treatment of arbitration clauses under the Magnuson-Moss Warranty Act²⁵ and the Dodd–Frank Wall Street Reform and Consumer Protection Act²⁶ as examples.

I. CONTRACTING FOR PROCEDURE

This Part provides a simple, informal model of dispute resolution choices to illustrate the tradeoff between differing types of procedural bundles.²⁷ Section I.A considers the situation where *ex ante* parties make a binary choice between courts and arbitration for the resolution of future disputes. Section I.B discusses parties that consider the possibility of unbundling procedure by claim or remedy—that is, by using carve-outs from or carve-ins to arbitration. Section I.C returns to the binary choice between courts and arbitration and instead considers the possibility that parties unbundle procedure by individually customizing the procedures that would apply to resolve their disputes. Section I.C models party decision-making as the existing literature on procedural customization assumes it occurs. Of course, claim and remedy customization and other procedural customization are by no means mutually exclusive.²⁸ Nevertheless, the framework in this Part provides a mechanism for thinking about the tradeoffs involved in the parties' choices.

25. Pub. L. No. 93-637, 88 Stat. 2183 (1975) (codified at 15 U.S.C. §§ 2301–2312 (2012)).

26. Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified at 12 U.S.C. §§ 5301–5641 (2012)).

27. The model developed in this Article starts with Professor Keith Hylton's framework for choosing between courts and arbitration. *See* Hylton, *supra* note 15, at 223–26. Like other scholars, Professor Hylton conceived of the parties' choice as binary, without considering the ways parties can choose to unbundle procedures. *Id.* at 223. Because unbundling by claim and remedy consists of a series of choices between courts and arbitration, Professor Hylton's framework provides solid foundation for this Article's general approach. This Article therefore borrows from and extends upon his analysis.

28. Of course, other contractual choices are possible. For example, parties could opt to attempt to resolve their disputes through mediation. Because mediation does not bind the parties, however, it is different in kind from, and can be used in conjunction with, both arbitration and courts. This Article, therefore, does not discuss contracting for mediation.

A. *Dispute Resolution as Binary Choice of Forum*

Scholars analyzing the contractual choice between litigation and arbitration have traditionally treated the decision as a binary one,²⁹ as reflected in Figure 1:

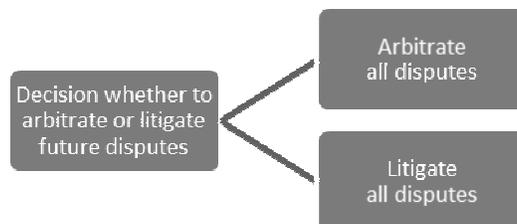


Figure 1—Binary Choice of Forum: Arbitration or Litigation

Many scholars have analyzed this choice as a straightforward determination based on the relative dispute resolution costs of arbitration and litigation, where “costs” are construed broadly to include dollars spent, time, convenience, etc. However, Professor Keith Hylton famously pointed out that the method of dispute resolution can provide “deterrence benefits” that should also be taken into account in any cost-benefit calculation.³⁰ For Professor Hylton, deterrence benefits are the social benefits associated with having a potential defendant take care to avoid harm to the other party, and the defendant’s incentive to take care can vary based on the liability he expects to face, which can in turn depend on the dispute resolution forum chosen by the parties.³¹ We adapt his conceptual analysis by focusing on “performance incentives” in lieu of deterrence benefits. Specifically, the choice between litigation and arbitration can influence the extent to which parties comply with their contractual obligations, both because it can affect the feasibility of vindication as well as the accuracy of liability determinations. An assessment of the relative virtues of choosing the forum should include those considerations.³²

Consider, for example, two features of the arbitral bundle of procedures that might reduce the costs to the parties of arbitrating their claims relative to litigation: (1) the ability to choose expert decision makers; and (2)

29. *E.g.*, Hylton, *supra* note 15, at 223; Richard R.W. Brooks & Sarath Sanga, *Commercial Arbitration Agreements Between Sophisticated Parties: An Empirical View* 5 (Feb. 24, 2013) (unpublished manuscript), available at <http://www.law.yale.edu/documents/pdf/cbl/BrooksSanga2013.pdf>.

30. Hylton, *supra* note 15, at 213.

31. *See id.*

32. *See id.* at 261.

limited discovery options available to the parties. Although each of these features of arbitration can reduce the cost of proceeding to arbitration, they can differentially affect the parties' incentives to behave well under the contract. Expert decision makers can decrease the likelihood of an erroneous decision, which would have the effect of incentivizing contractual performance.³³ In contrast, limited discovery might hamper a plaintiff's ability to establish her claims, which could increase the likelihood of an erroneous decision relative to litigation, and therefore decrease performance incentives.³⁴ When making a binary determination between courts and arbitration, parties must weigh the overall cost considerations together with the overall effect that the procedures will have on the likelihood that the parties will perform as carefully as promised.

In Figure 1, parties will choose arbitration over litigation if the net benefits to arbitration exceed the net benefits to litigation, taking all possible claims and disputes into account. The net benefits of arbitration include the performance incentives from arbitration minus the costs of proceeding to arbitration. Similarly, the net benefits of litigation include the performance incentives from litigation minus the costs of proceeding with litigation. Specifically, if one assumes that the defendant's failure to perform as promised can increase the probability (and perhaps the magnitude) of harm suffered by the plaintiff, then the performance incentives associated with defendant's care include the marginal decrease in expected harm to the plaintiff minus the cost to the defendant of taking those performance precautions.³⁵

The various features of arbitration and litigation can influence the probability that the defendant will perform as promised. In Figure 1, the forum choice is binary so that the net effect on this probability is determined in the aggregate. As a result, expected performance incentives are equal to the probability the defendant will perform, given the dispute resolution forum chosen, multiplied by the net benefits of performing. Expected dispute resolution costs are simply the sum of the expected costs to each party of resolving their disputes in a particular forum. If the parties' forum decision is binary, then the parties will choose to arbitrate rather than litigate their claims when the performance incentives from arbitration minus the costs of arbitrating exceed the performance incentives of litigating in court minus the costs of litigating.³⁶

33. Drahozal, *supra* note 18, at 751.

34. *See id.* at 752.

35. Thus, if: LL = expected harm to the potential plaintiff when the defendant does not take precautions to ensure performance,; Ls = expected harm to the potential plaintiff when the defendant does take precautions, and X = cost of precautions to the defendant, then, the expected performance incentives associated with the defendant taking precautions are equal to: $LL - Ls - X$.

36. Stated otherwise, denoting P as the probability the defendant will take care, if expected performance incentives for a particular forum equal $P(LL - Ls - X)$ and expected dispute resolution costs to plaintiff and defendant equal $ECP + ECD$, the parties will agree to arbitration when:

Again adapting Professor Hylton's analysis,³⁷ parties will decide to arbitrate whenever the joint benefits of arbitration exceed its joint costs. However, that conclusion only holds in a world without transaction costs. In reality, the parties that opt for arbitration incur costs of negotiating and then drafting arbitration clauses. This Article removes the assumption of zero transaction costs.³⁸ In particular, parties who opt for litigation need not include any provisions in their contracts,³⁹ but parties opting for arbitration must specify that preference and then ideally further specify information about their preference (or not) for an arbitration provider, an arbitration venue, governing rules, etc.⁴⁰ These costs are labeled the "specification costs" of drafting a generalized arbitration clause.⁴¹ Specification costs also include the possibility that individuals are boundedly rational and therefore strongly prefer not to make decisions along many dimensions.⁴² Thus, still assuming a binary choice, parties would choose to arbitrate rather than litigate their future disputes if the performance incentives to arbitrating minus the expected arbitration costs, minus the cost of contract specification exceed the performance incentives of litigation minus expected litigation costs.⁴³

B. *Dispute Resolution with Procedures Unbundled by Claim or Remedy (i.e., with Carve-Outs and Carve-Ins)*

$$\text{Equation 1: } Pa(LLa - L Sa - Xa) - [ECPa + ECDA] > Pc(LLc - L Sc - Xc) - [ECPc + ECDC].$$

37. Hylton, *supra* note 15, at 263 (concluding that parties will arbitrate when the social benefits exceed the social costs).

38. Professor Hylton also considers that parties do not pay the full cost of the court system (court systems are heavily subsidized by tax revenues). Thus, when parties opt for court resolution of their claims, they do not actually internalize the costs of using court personnel. *See id.* at 213. For simplicity, this Article ignores the potential problem of assuming that courts are costless here, but it will consider this defect when analyzing the policy implications of the analysis in Part III.

39. However, if parties wish to agree to litigation in a particular forum, then litigation would have specification costs as well.

40. *See generally* GARY B. BORN, INTERNATIONAL ARBITRATION AND FORUM SELECTION AGREEMENTS: DRAFTING AND ENFORCING (3d ed. 2010) (discussing possible provisions to include in arbitration agreements); PAUL D. FRIEDLAND, ARBITRATION CLAUSES FOR INTERNATIONAL CONTRACTS (2d ed. 2007) (same).

41. The specification costs here may at times offset savings in specification costs elsewhere in the contract. Thus, arbitration by an expert decision maker might enable the parties to avoid specifying performance duties (although it could also increase other specification costs due to the fact that the focus on dispute resolution makes the parties rethink other contract terms). For simplicity, we hold the other contract specification costs constant in order to focus on these ignored but important costs of choosing arbitration.

42. *See, e.g.*, Joseph A. Grundfest & Peter H. Huang, *The Unexpected Value of Litigation: A Real Options Perspective*, 58 STAN. L. REV. 1267, 1275 (2006).

43. Or when:

$$\text{Equation 2: } Pa(LLa - L Sa - Xa) - [ECPa + ECDA] - SC(arb)P,D > Pc(LLc - L Sc - Xc) - [ECPc + ECDC]$$

where $SC(arb)P,D$ represents the specification costs incurred by the parties.

In reality, however, the choice between litigation and arbitration is not binary; in many contractual settings parties choose the litigation bundle of procedures for most claims but reserve the right to take particular claims or determinations to arbitration. Alternatively, parties who have chosen an arbitral bundle of procedures for most of their claims regularly reserve a right to litigate certain claims, obtain certain remedies in court, or both. This Article refers to these more specific decisions as carve-ins in the first case, and carve-outs in the second case. As modelled, this decision-making process is two-staged. The first stage entails the decision about whether the parties generally wish to resolve disputes in court or arbitration. The second stage addresses whether to carve in or carve out exceptions. Thus, the parties' decisions are represented by the matrix presented in Figure 2:

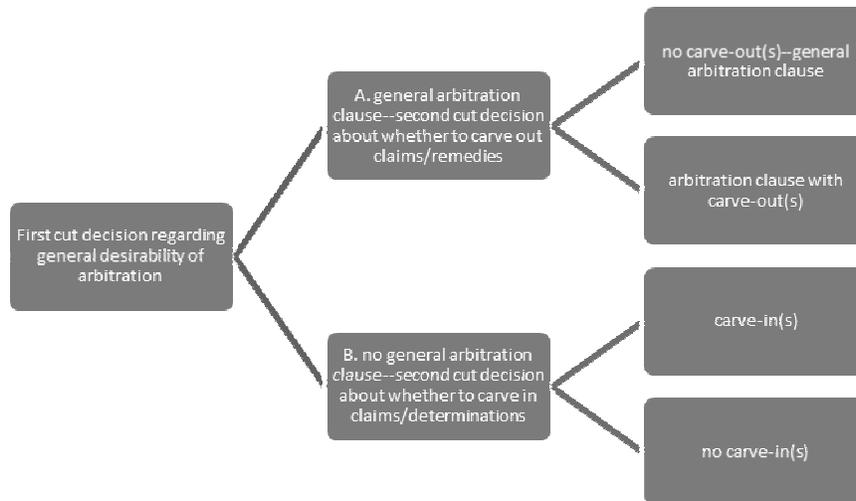


Figure 2—Decision Matrix with Claim/Remedy Specific Determinations

As indicated above, Professor Hylton’s analysis assumes that parties must make an all-or-nothing choice between arbitration and litigation.⁴⁴ Under his analysis, the parties will choose the socially optimal result after taking into account the overall costs and benefits of choosing courts versus arbitration.⁴⁵ But with such binary decision-making, it remains entirely possible that the parties have chosen a suboptimal method of resolving particular types of claims or disputes under the contract. If parties are able to unbundle the applicable procedures by claim or remedy, they may be able to construct a dispute resolution clause that makes them better off than an all-or-nothing choice of litigation or arbitration. In other words, this

44. See *supra* text accompanying notes 29–30.

45. Hylton, *supra* note 15, at 223–25.

analysis removes the assumption that the parties' decisions are binary.

Figure 2 depicts the decision process of the parties.⁴⁶ At the first decision node in Figure 2, the parties must choose whether to start with the background assumption that they will generally arbitrate or litigate their claims. Borrowing the analysis from Section I.A above, parties would choose a default rule of arbitration rather than litigation if, for a majority of claims, the performance incentives to arbitrating minus the expected arbitration costs minus the cost of contract specification exceed the performance incentives of litigation minus expected litigation costs. This decision reflects the parties' judgment about the best procedure for resolving a majority of the parties' disputes, even if a subset of the claims would be better resolved by other procedures.

Once the parties choose arbitration or litigation for most disputes, they face a second decision regarding whether to carve-out or carve-in particular claims or remedies for separate treatment. Unbundling procedures by claims and remedies enables the parties to choose dispute resolution mechanisms that further maximize their joint benefits. Consider, for example, the situation in which parties find themselves at decision node A in Figure 2. Although these parties will have chosen to arbitrate most claims, they might reserve a right to litigate a subset of possible claims. As explained further below, parties might prefer the court bundle of procedures in a number of circumstances, particularly when the primary form of relief sought is injunctive relief (including preliminary injunctions and other provisional remedies), when the merits of the case are likely clear, and when the parties perceive the stakes of a possible dispute as very high.⁴⁷

Conversely, parties located at decision node B in Figure 2 have chosen to litigate the bulk of their claims, yet some might be better resolved using the arbitral bundle of procedures. For example, industry experts might be better situated to make certain factual determinations, such as calculating a bonus provision or other valuation or making substantial performance determinations.⁴⁸ Parties also might prefer arbitration to litigation in circumstances where cross-border enforcement is contemplated.⁴⁹ Relatively small claims also might be more viable in arbitration, where formalized procedures can be relaxed and attorney representation might be

46. Figure 2 might not accurately represent the decision-making process of all parties in that the decision regarding the treatment of particular claims may be part and parcel of the parties' background choice to use the courts or arbitration. In particular, for some parties, arbitration is made appealing only after some claims are set aside for courts. This Article treats the two decisions separately here in order to promote ease of analysis, but nothing turns on the particular presentation.

47. See Drahozal & Ware, *supra* note 15, at 453–57.

48. See Brian JM Quinn, *Putting Your Money Where Your Mouth Is: The Performance of Earnouts in Corporate Acquisitions*, 81 U. CINN. L. REV. 127, 170 (2013) (“Earnout provisions ... tend to require that disputes be brought to private arbitration rather than through the courts.”).

49. E.g., BÜHRING-UHLE, *supra* note 15, at 136.

unnecessary.⁵⁰

The question of carve-outs (decision node A) involves an initial determination to utilize arbitration as a matter of default. Parties will incorporate carve-outs into their agreement when the net benefits to litigation exceed the net benefits to arbitration for that matter. However, the parties incur the drafting costs of including carve-outs when they opt for litigation rather than arbitration to treat some individual claims. The drafting costs of specifying litigation of a claim or remedy include the costs of negotiating for court resolution of that claim or remedy and the cost of drafting a relevant clause (which could, but need not, include a provision specifying the court where such claim or relief would be sought).

This more fine-tuned calibration could entail significant costs. With carve-outs, the parties must contemplate specific types of future disputes and even potential issues that might arise in the course of those disputes. Then they must carefully describe (in a way that prevents courts from intruding into the wrong disputes or becoming involved in line drawing) which disputes fall into the carve-out provision. In addition to these additional drafting costs, parties who choose to carve-out some claims for litigation might incur “bifurcation costs,” which are the costs of having a party’s dispute divided between two forums because that dispute involves multiple claims, only some of which fall within the agreement to arbitrate.⁵¹ Practitioners cite these drafting and bifurcation costs as reasons not to carve out claims from an arbitration clause⁵² (indeed, the widespread

50. *E.g.*, *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 281 (1995) (“[Permitting businesses to avoid a pre-dispute arbitration clause might] leav[e] the typical consumer who has only a small damages claim . . . without any remedy but a court remedy, the costs and delays of which could eat up the value of an eventual small recovery.”); *see also* Theodore Eisenberg & Elizabeth Hill, *Arbitration and Litigation of Employment Claims: An Empirical Comparison*, 58 DISP. RESOL. J., Nov. 2003–Jan. 2004, at 44, 45 (finding evidence that “lower-paid employees seem to lack ready access to court”).

51. Whenever parties choose to arbitrate claims, they risk incurring a second type of bifurcation cost, whereby they must proceed in court to determine some matters, including whether the arbitration clause is enforceable and whether the courts should provide preliminary relief. Then they proceed to arbitration to resolve the underlying claim, at which point they might need to turn back to the courts to enforce the arbitration award. Arbitration law minimizes these bifurcation costs by severely limiting the role of courts in scrutinizing arbitration agreements and awards. Nevertheless, these costs exist, and they are likely more significant in cases where parties seek temporary or permanent injunctive relief. Part II further explores this second type of bifurcation cost, but this Article leaves it out of the textual analysis here so as not to unduly confuse the reader.

52. *E.g.*, 1 BORN, *supra* note 15, at 1128 (“The enforceability of [carve-outs for payment obligations] is not subject to serious doubts. In general, however, sophisticated advisers counsel against this approach. The jurisdictional and other uncertainties that result from such a bifurcated dispute resolution scheme usually outweigh any potential benefits.”); Kenneth Mathieu & Vincent P. (Trace) Schmeltz III, *Dispute Resolution as a Part of Your Merger or Your Acquisition Agreement*, 1 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. 61, 74 (2012) (noting that narrow provisions lead to ancillary litigation, namely, about whether the parties “have or have not delegated an issue to the arbitrator”).

presence of carve-outs has come as a surprise to some practitioners with whom the authors have spoken).

Thus, informed decision makers at node A will include carve-outs in an agreement only if the net benefits to arbitrating the claims (performance incentives of arbitration minus expected arbitration costs) are less than the net benefits of litigating the claims (performance incentives of litigation minus expected litigation costs minus the specification costs of including carve-outs minus expected bifurcation costs).⁵³ Otherwise, the parties will choose the no-carve-out option.

Informed parties at decision node B have decided to retain the default court bundle of procedures for resolving most claims, and they face the question of whether to carve in some of their claims or issues for determination in arbitration. In this case, carving in entails specification costs, including both the costs of choosing (or not) an arbitral forum, governing rules, etc., but also involves the costs of carefully specifying which claims ultimately should be arbitrated. In addition, the decision to use carve-ins can entail bifurcation costs.⁵⁴ To justify a carve-in, arbitration of the particular matter must add performance incentives or decrease dispute resolution costs relative to litigation, and those advantages must be large enough to offset the accompanying specification and bifurcation costs. Conversely, to justify a carve-out, litigation of the particular matter must add performance incentives or decrease dispute resolution costs relative to arbitration, and those advantages need to be large enough to offset the accompanying specification and bifurcation costs.

Stated otherwise, carve-outs and carve-ins enable parties to unbundle dispute resolution procedures where it is efficient to do so. To illustrate: According to the arbitration literature (and practitioner surveys), parties often seek arbitration as a low-cost mechanism for resolving disputes.⁵⁵ To

53. Or when:

$$\text{Equation 3: } Pa(\text{carve-out})(LLa - LSa - Xa) - [EC(\text{carve-out})Pa + EC(\text{carve-out})Da] < Pc(\text{carve-out})(LLc - LSc - Xc) - [EC(\text{carve-out})Pc + EC(\text{carve-out})Dc] - SC(\text{carve-out})P,D - [EBC(\text{carve-out})P + EBC(\text{carve-out})D]$$

where $SC(\text{carve-out})P,D$ represents the specification costs of carving out claims or relief and $[EBC(\text{carve-out})P + EBC(\text{carve-out})D]$ represents the expected bifurcation costs to each party of possibly having to proceed in two different forums in the event of dispute.

54. Thus, we can expect parties to use carve-ins only when:

$$\text{Equation 4: } Pa(\text{carve-in})(LLa - LSa - Xa) - [EC(\text{carve-in})Pa + EC(\text{carve-in})Da] - SC(\text{carve-in})P,D - [EBC(\text{carve-in})P + EBC(\text{carve-in})D] > Pc(\text{carve-in})(LLc - LSc - Xc) - [EC(\text{carve-in})Pc + EC(\text{carve-in})Dc]$$

55. *E.g.*, DOUGLAS SHONTZ ET AL., RAND INST. FOR CIVIL JUSTICE, BUSINESS-TO-BUSINESS ARBITRATION IN THE UNITED STATES: PERCEPTIONS OF CORPORATE COUNSEL 4, 9–10 (2011), available at http://www.rand.org/content/dam/rand/pubs/technical_reports/2011/RAND_TR781.pdf (surveying 121 corporate counsel and finding that most believe that arbitration saves money when compared with litigation). For a summary of other relevant surveys, see Christopher R. Drahozal, *Arbitration Costs and Forum Accessibility: Empirical Evidence*, 41 U. MICH. J.L. REFORM 813, 826–29 (2008).

ensure that arbitration is cheap, however, there can be an inevitable tradeoff between cost and accuracy.⁵⁶ Parties generally preferring a low-cost arbitration forum (and rules) might instead opt for a more expensive forum to ensure that they can obtain a high-quality determination when accuracy really matters. The carve-out enables the parties to get the benefit of low-cost arbitration and use courts when the added costs are justified.

The opposite can be true as well. Sophisticated international parties might opt for International Chamber of Commerce (ICC) arbitration, which is expensive but very high quality (higher than for most courts),⁵⁷ but carve out some claims for court resolution when the higher costs of arbitration are unjustified. In each case, the parties are better off than they would be if they compromised by choosing mid-level cost and accuracy for all of their claims. Sometimes parties can achieve this tailoring without carve-outs or carve-ins by, for example, choosing an arbitral forum that offers both types of dispute resolution and allowing the forum (or the parties after the fact) to choose the appropriate dispute resolution mechanism. But carve-ins and carve-outs are justified when the parties are unlikely to agree *ex post* and the arbitration provider's decision cannot be trusted (incentive incompatible) or when other potential benefits are obtainable with carve-outs or carve-ins. If parties opt for high-end or low-end arbitration, then this analysis would predict a higher incidence of claim carve-outs, all else being equal.

Carve-ins and carve-outs can serve an additional function not reflected in the analysis provided above. Specifically, they can help the parties address uncertainty regarding the appropriate treatment of cases within a particular claim category. The analysis above assumed that, on net, particular types of claims are better suited for arbitration or courts. Although it might generally be possible to make such conclusions for claims categories, parties might face considerable uncertainty regarding the appropriate treatment of individual claims within a category. Thus, for example, broad discovery rights might not be important for most disputes within a given category of high-value claims, but accurate resolution of some disputes might turn on the ability to use broad discovery. In that situation, a party might want the option to proceed to court for those cases even though for other potential cases the costs of litigating the claims (bifurcated proceedings plus additional dispute resolution costs) would be unjustified.⁵⁸

Consider also the situation where the value of some claims in a

56. Drahozal, *supra* note 18, at 752–53.

57. See ICC ARBITRATION RULES, *supra* note 10.

58. Patrick Bolton and Antoine Faure-Grimaud developed a model showing that when it is too costly to think through remote contingencies *ex ante*, boundedly rational parties might agree to provide one party with options as control rights which can be exercised *ex post*. See Patrick Bolton & Antoine Faure-Grimaud, *Satisficing Contracts*, 77 REV. ECON. STUD. 937, 938 (2010).

category cannot be known unless the plaintiff has a right to broad discovery without incurring high up-front costs.⁵⁹ Here too, the party might value the option of bringing some claims to court, where filing fees are lower. In these cases, retaining the litigation option can significantly influence performance incentives because it helps to ensure that meritorious cases are in fact brought. Consistent with this analysis, carve-outs and carve-ins can be (and often are) drafted to provide one of the parties with the option, rather than a duty, to proceed in court (or arbitration) for the specified category of matters. Having the option in the face of uncertainty—i.e., where potential suits within a claim category are heterogeneous—enables the parties to further maximize the joint benefits of dispute resolution decisions.

C. Dispute Resolution as a Binary Forum Choice with à la Carte Procedures

Now consider procedural unbundling by use of customized or à la carte procedures. Parties make a binary choice between court and arbitration, but they can customize the specific procedures applied by the forum. As in Section I.B, this Section models the parties' choice as a two-stage decision. In stage 1, parties choose the forum. In stage 2, the parties decide whether to customize the procedures. In reality, the customization choice could conceivably influence the forum choice, but here the assumption is that the parties will pick the forum that comes closest to their preferred procedures and then decide whether it is worth the additional effort necessary to further tailor the procedures to their needs. Figure 3 represents the parties' decision matrix:

59. In a model presented by Huang and Grundfest, variance in the expected value of a lawsuit can induce litigation even in "negative-value" suit contexts because cheap discovery provides plaintiffs with more information about the actual value of their lawsuit, which could in fact turn out to have positive-value. See Grundfest & Huang, *supra* note 42, at 1276–77, 1287–88.

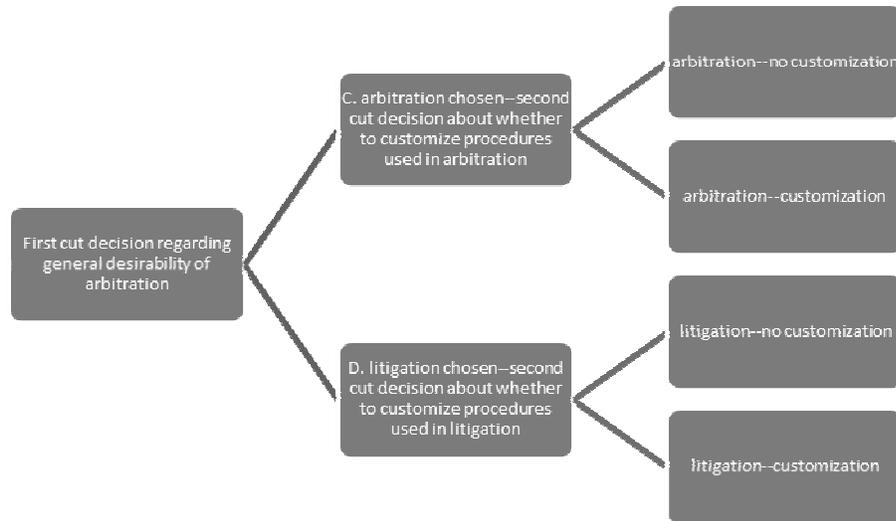


Figure 3—Decision Matrix with Customized Procedure Determinations

The stage 1 decision—the choice between decision nodes C and D—entails the costs and benefits described in Section I.A. Specifically, the parties will choose arbitration as their forum if, and only if, the performance incentives to arbitration minus the expected costs of arbitration, minus the specification costs of arbitration (without customization) exceed the performance incentives to court resolution minus the expected costs of proceeding in court. Costs and benefits here are calculated by aggregating the costs and benefits across contract risks and their accompanying claims.

Once the parties initially decide whether to arbitrate or litigate, they then decide whether to customize the procedures. Parties that choose arbitration, located at node C, must decide whether to customize the arbitration procedures. Here, the model assumes that the parties have chosen an arbitration provider and an off-the-rack set of rules offered by the provider. The question the parties then face is whether to customize the default procedures (represented by their choices of forum and governing rules) along one or more dimensions. Parties would choose to customize the arbitration procedures where the added performance incentives to customized arbitration minus the incremental costs of the customized arbitration exceed the specification costs associated with the customization.⁶⁰

60. Or when:

$$\text{Equation 5: } Pa(\text{customize})(LLa - LSa - Xa) - [EC(\text{customize})Pa + EC(\text{customize})Da] > SC(\text{customize})P,D.$$

For many potential customizations, this condition is unlikely to hold. Consider first the marginal benefit of customization for the parties. Without customization, the parties have chosen an arbitration provider that generally operates according to its needs (or at least comes closer than other available options) and off-the-rack rules that further align the parties' preferences with the proceedings. Any specific customization can improve on these off-the-rack rules administered by the chosen provider. Because the parties have already chosen the set of default rules that best suit their needs, presumably, the benefits of customization will only be marginal. Moreover, that customization will apply to all of the parties' claims, and for many customizations, the net benefits can operate in opposite directions across claims. For example, a customization requiring that the arbitrator be an industry expert will lower the cost of some claims (substituting away from the need to engage in costly proof exercises) and provide greater accuracy (and therefore greater performance incentives). For other claims, however, accurate resolution will not require that the arbitrator be an industry expert. In those cases, the expert does not add to performance incentives and could actually increase the cost of dispute resolution, assuming that experts charge more than nonexperts and that there is no reduction in party effort to prove the claim.

More generally, because off-the-rack rules tend to provide arbitrators with considerable discretion,⁶¹ customization can inhibit the flexibility of the arbitrator. Limiting the arbitrator's flexibility can be problematic if that flexibility would otherwise enable her to apply optimal procedures to each claim.⁶² Consider, for example, customization of the parties' rights to discovery or the presentation of evidence in the event of a dispute. Narrow discovery rights and evidence rules tend to enable the parties to conserve dispute resolution costs at the expense of accuracy, while broader discovery rights and evidence rules increase the cost of dispute resolution but can increase accuracy.⁶³ Without *ex ante* specification, arbitrators might find some leeway in the governing procedural rules to at least

61. Professor William Park has lamented the broad procedural discretion given to arbitrators, calling for more specific rules to cabin their discretion. William W. Park, *The 2002 Freshfields Lecture—Arbitration's Protean Nature: The Value of Rules and the Risks of Discretion*, 19 ARB. INT'L 279, 283 (2003). The absence of much, if any, movement in that direction supports the contrary view stated here.

62. Note that the conclusion here is the converse of that found in the literature on economic development, where scholars promote rules rather than standards for use in developing national courts in order to check judicial corruption and incompetence. See, e.g., Jonathan R. Hay & Andrei Shleifer, *Private Enforcement of Public Laws: A Theory of Legal Reform*, 88 AM. ECON. REV. PAPERS & PROC. 398, 400 (1998). Here, party control over the choice of arbitrator should generally protect against corruption and incompetence, although in cases where parties use arbitration for cheap and quick conflict resolution (e.g., eBay disputes), less discretion might be preferred.

63. See Drahozal, *supra* note 18, at 752–53.

partially tailor discovery and evidence to the type of claim at issue.⁶⁴ If so, the arbitrator could use that discretion to ensure that the marginal benefit of increased accuracy for the dispute justified the additional dispute resolution costs. No doubt arbitrators can make errors in judging which available procedures maximize performance incentives at the lowest cost. Parties nervous about such errors might want to specify procedures to reduce those errors. *Ex ante*, however, those errors may appear less costly than the parties' rigid imposition of a procedural rule to be applied to the resolution of all future disputes.

The specification costs of customization are likely to be large relative to the net benefits. The costs of physically drafting a customization are likely insignificant, especially for high-value contracts. However, the cost of anticipating the universe of possible disputes and ensuring that the customization provides a net benefit to the parties could be quite significant.⁶⁵ Errors deprive the arbitrator of a flexible application of available procedures. Contrast these specification costs to those present in the context of carve-outs and carve-ins. With carve-outs, the parties decide that, although they generally prefer to resolve their disputes with arbitration, for one or more claims they prefer an option to proceed in courts. With carve-ins, the parties decide to use courts with the exception of one or more claims. In each context, the exceptions work to increase the expected welfare of the parties because the parties believe that a particular risk should be treated in a different way. Presumably, the parties can realize that increased welfare without having to consider the universe of possible claims or contexts where disputes might arise. A specific claim or form of remedy can be separated out for particularized negotiation and treatment. In general, then, this analysis would predict the specification costs of customizing specific procedural rules to be greater than the specification costs of including carve-outs or carve-ins.

Parties that choose courts, located at node D, must also decide whether

64. See, e.g., AM. ARBITRATION ASS'N, INT'L CENTRE FOR DISPUTE RESOLUTION: INT'L ARBITRATION RULES art. 20.1 (2014), available at <https://www.adr.org/aaa/ShowPDF?url=/cs/groups/international/documents/document/z2uy/mdiw/~edisp/adrstage2020422.pdf> ("Subject to these Rules, the arbitral tribunal may conduct the arbitration in whatever manner it considers appropriate . . ."); ICC ARBITRATION RULES, *supra* note 10, art. 22(2) ("In order to ensure effective case management, the arbitral tribunal, after consulting the parties, may adopt such procedural measures as it considers appropriate, provided that they are not contrary to any agreement of the parties."); JAMS EMPLOYMENT ARBITRATION RULES & PROCEDURES, *supra* note 10, R. 17(b) ("Absent agreement, the Arbitrator shall determine [deposition] issues including whether to grant a request for additional depositions, based upon the reasonable need for the requested information, the availability of other discovery, and the burdensomeness of the request on the opposing Parties and witness.").

65. See Park, *supra* note 61, at 296 ("[S]pecific rules might cause some lawyers to counsel against arbitration, from fear of losing their margin to manoeuvre once the dispute arises. Prior to the arbitration, parties do not necessarily know what rules will benefit them on matters such as discovery and punitive damages." (footnote omitted)).

to customize the procedures applied in court. Similar to the decision faced by parties at node C, these parties should customize when the net performance incentives to customization minus any cost increase are greater than the specification costs of customization.⁶⁶ The costs and benefits here are presumably similar to those faced by the parties at node C with three possible differences. First, the parties may be less confident that a judge will have procedural discretion or will use it in beneficial ways. Thus, the hampering of performance incentives to customization is likely smaller. Second, the cost savings to customization could be larger because, unlike arbitration providers, courts are not developing menus of off-the-rack rules that pretend to suit parties well.⁶⁷ Third, the parties might think that they are limited in the extent to which they can customize their procedures.⁶⁸ Parties might think that they can get away with customizing one or two features of court dispute resolution but limit their provisions out of a fear that judges would balk at numerous specifications that change the judge's perceived role. If so, then the performance incentives and cost savings might be limited, with the specification costs still high. But generally, although parties have relatively little incentive to specialize procedures in courts or arbitration, it is not clearly the case that the parties' incentives are lower when they opt for court resolution of their disputes.

In summary, relative to untailored, all-or-nothing, forum-selection clauses, procedural unbundling through customized procedural rules promises greater performance incentives and lower process costs, but applying those customized procedures to all possible disputes can entail much higher specification costs. Moreover, customized procedural rules can hamper the decision maker's flexibility in ways that actually reduce performance incentives. Arbitration clauses that opt for carve-outs rather than customization can be used to obtain greater performance incentives and lower process costs than all-or-nothing forum-selection rules, but they introduce increased specification costs and bifurcation costs. Relative to customized procedural rules, carve-outs could impose higher dispute-resolution costs, but the effect on performance incentives is uncertain. At the same time, carve-outs create bifurcation costs, but their ability to align customizations with differing risks suggests that their specification costs would be much lower.⁶⁹

66. Or when:

$$\text{Equation 6: } Pc(\text{customize})(LLc - LSc - Xc) - [EC(\text{customize})Pc + EC(\text{customize})Dc] > SC(\text{customize}).$$

67. Of course, business courts might provide an exception here, but the point is that arbitration providers typically engage in more menu development than do courts.

68. See Bone, *supra* note 17, at 1351 ("For without formal assurance of legal enforcement [of party procedural rulemaking], parties would have trouble making credible commitments.").

69. As noted above, *supra* note 18, this Article focuses on *ex ante* rather than *ex post* procedural unbundling. As such, the models presented here simplify reality by assuming away the possibility of *ex post* customization. To the extent parties can agree to *ex post* customization at low

Ultimately, the relative costs and benefits of these differing choices of procedural bundles is an empirical question, as is the possibility that the parties could choose some of each type of bundling to resolve disputes. As discussed above, the existing empirical studies find little evidence of unbundling through detailed customization of procedures in contracts between sophisticated parties.⁷⁰ The next Part examines the extent to which parties contract for procedural unbundling by claim or remedy with carve-outs.

II. UNBUNDLING PROCEDURE BY CLAIM AND REMEDY: DATA AND FINDINGS

This Part examines empirically the use of procedural unbundling by carve-outs in a wide range of contracts, including CEO employment contracts; domestic, foreign, and cross-border agreements entered into by technology firms; domestic and international joint venture agreements; franchise agreements; and mobile wireless service contracts.⁷¹ At least three of these categories of contracts involve two sophisticated parties with substantial bargaining power.⁷² In addition, two of the categories enable a comparison of contracting behavior between U.S. firms and others, particularly those located in China. A comparison across contract types and industries provides a glimpse of the circumstances where carve-outs seem most useful.

The contracts studied here nevertheless create inevitable selection bias in that we purposefully focus on contracts where arbitration clauses are commonly used. It has not yet been possible to study these arbitration clauses in many contractual settings. Moreover, many (although not all) of the contracts were obtained through the SEC's EDGAR database, which contains only those contracts considered of "high value" to the firm.⁷³ Although the findings here can therefore provide only tentative conclusions about party use of carve-outs, much can be said, at least initially, about their incidence and functions. The central findings of the studies are as follows:

cost, it would reduce their incentive to agree to *ex ante* customization as well as, possibly, their incentive to use carve outs. Ultimately, how parties respond to the various alternatives is an empirical question, and this Article's findings suggest that they frequently agree to use carve-outs.

70. See *supra* text accompanying note 20.

71. The Article focuses here on carve-outs rather than carve-ins because the use of carve-outs is much more common, facilitating our empirical analysis. Of course, the apparent rarity of carve-ins itself is a relevant data point.

72. See *infra* text accompanying notes 74–108.

73. For example, the contracts collected from SEC filings are limited to contracts "material" to the corporation and likely do not include many contracts from business's day-to-day operations. Drahozal & Ware, *supra* note 15, at 458–59.

1. Carve-out rates vary across the contracts studied. Carve-outs are present in essentially all franchise contract arbitration clauses, nearly two-thirds of domestic and cross-border technology contract arbitration clauses, and about one-half of domestic joint venture agreement arbitration clauses and CEO employment contract arbitration clauses. With one exception noted in conclusion five, carve-outs are included in relatively few international and foreign agreements. Specific types of carve-outs are present with varying rates across industries and contract type. This suggests that parties take into account the relative costs and benefits of using such carve-outs.

2. Carve-outs are used more often for claims where the parties will seek primarily property-type protections, or injunctive relief. The carve-outs suggest that injunctive relief is more valuable to the parties when it is backed by state force. Court resolution of these matters likely provides significantly higher performance incentives. Parties could, and often do, simply carve out a right to go to court for preliminary injunctive relief, permanent injunctive relief, or both. But in many cases, parties carve out the whole claim for court resolution. This suggests that parties seek potential cost savings associated with having a court decide the whole matter. Otherwise, the parties must go to court seeking preliminary relief, return to the arbitrator for resolution of the merits of the claim, and then back to court for permanent injunctive relief. Apparently, some parties forecast that the cost savings of carving out the claim entirely is greater than the possible bifurcation costs associated with having some claims resolved in court while others are resolved in arbitration.

3. Carve-outs are broadly used as a tool to protect the value of information, innovation, and reputation. Using courts to protect information seems counterintuitive at first, because one commonly suggested virtue of arbitration is its ability to enable the parties to maintain confidentiality. However, as explained below, information is often best protected with injunctive relief, a remedy that courts are more effective at providing. To the extent technological advances suggest that contracts derive larger fractions of their value from information and innovation over time, one can forecast an increasing reliance on the use of carve-outs.

4. Carve-outs are used in circumstances where it is plausible that the parties value in rem or other determinations that could affect the rights of third parties to the litigation (i.e. claims

regarding patent validity, the use of confidential information, and the ability to hire another firm's employees). Because arbitration can only settle the rights of the parties litigating a particular matter, there may be increased performance incentives and decreased overall dispute resolution costs to having such actions settled in courts.

5. For those types of contracts where protection of information and innovation seem more important to the contract's value (i.e., franchise and technology contracts), carve-outs are more prevalent. This is true even in the case of cross-border contracts, where the enhanced cross-border enforceability of arbitration awards should deter parties from using courts to resolve any claims.

6. In the cases of protection of information, innovation, reputation, and property, the carve-outs often seem to benefit one party to the agreement. If that party has substantial bargaining power in the drafting of the contract, carve-outs will appear at very high rates. For example, carve-outs are found in almost all franchise contracts where the franchisor commonly has more bargaining power. Where bargaining power is more equal, carve-outs are still common but appear somewhat less frequently, as is the case for domestic joint venture agreements and CEO employment contracts. The fact that carve-outs are still found in half of the latter arbitration clauses suggests that the increased performance incentives of the carve-outs can create mutual benefits to parties. However, the increased specification costs (including negotiation) and bifurcation costs must be shared jointly and could work to hinder the presence of carve-outs somewhat.

7. Parties also sometimes carve out small claims and claims for moneys owed, suggesting a motivation to reduce dispute resolution costs. For example, arbitration can be more expensive than litigation for debt collection cases because of the need to confirm an arbitration award in court before creditors' remedies can be used.

8. In general, U.S. contracting parties use carve-outs more often than parties located in other countries. This could be a function of the U.S. lawyer culture, or it could be a byproduct of parties in other countries being less certain of the reliability of their own court systems.

9. Parties can only benefit from carve-outs when (a) they trust courts to better protect their interests than arbitrators; and (b) courts will enforce the arbitration clauses with the carve-outs. The technology contracts and international joint venture agreements studied provide powerful evidence that the first requirement is not satisfied for parties located in China. Carve-outs are almost never found in these contracts. In addition, the CEO employment contracts provide evidence that California courts' failure to satisfy the second requirement hinders the ability of contracting parties in that state to reap the benefits of carve-outs in employment contracts. In short, this form of wealth enhancement requires well-functioning and cooperative courts.

A. CEO Employment Contracts

In a follow up to a 2010 article,⁷⁴ O'Hara O'Connor, Martin, and Thomas analyzed a sample of CEO employment contracts for companies included in the S&P 1500 during 1995–2005.⁷⁵ The authors coded 910 initial and restated contracts⁷⁶ filed by those companies with the SEC and available on LiveEdgar.⁷⁷ They then coded the contracts for the presence of a number of provisions contained within different arbitration clauses.⁷⁸ The parties agreed to arbitrate all of their disputes (though perhaps with carve-outs) in 458 of these contracts. The parties agreed to arbitrate only some of their disputes (“carve-ins”) in 5 of the contracts, and provided options to arbitrate in another 6 of the contracts. Of the 910 contracts studied, 469 contracts (51.5%) included an arbitration provision.⁷⁹

Of the arbitration clauses in the sample, 219 (47%) included one or more carve-outs—that is, specific provisions within the arbitration section of the agreement that listed one or more exceptions to, or exclusions from, the arbitration agreement.⁸⁰ Table 1 lists the carve-outs found in the arbitration clauses and the frequency with which they were present:

74. See Randall Thomas et al., *Arbitration Clauses in CEO Employment Contracts: An Empirical and Theoretical Analysis*, 63 VAND. L. REV. 959, 977–82 (2010).

75. O'Hara O'Connor et al., *supra* note 20, at 158.

76. *Id.* at 159. Restated contracts are those that are drafted after amendment or renewal with the intention of replacing the parties' initial contract. *Id.*

77. See *id.* at 158–60 (describing the contract collection and coding methodology). The study started with 1,970 CEO employment contracts, but many took the form of contract amendments, which were eliminated from the sample once it became clear that the amendments were short, tended to address only one or two matters, and tended not to address dispute resolution. *Id.* at 158–59.

78. *Id.* at 159–60.

79. *Id.* at 160. For a full description of the details of the arbitration clauses in these contracts, see generally O'Hara O'Connor et al., *supra* note 20, at 162–77.

80. *Id.* at 168.

Type of carve-out	# of contracts with carve-out	% of arbitration clauses with carve-out
Any carve-out	219	47%
Noncompete clause claims	144	32%
Confidentiality clause claims	166	37%
Client nonsolicitation clause claims	99	22%
Employee nonsolicitation clause claims	137	30%
Nondisparagement clause claims	30	7%
Preliminary relief carve-out	56	12%

A noncompete clause carve-out was present in a contract that included: (1) a noncompete clause, which is a clause under which the CEO agrees not to work for a competitor or to open a business that competes with the company for some period of time after the CEO's employment terminates; (2) an arbitration clause; and (3) a clause providing that, notwithstanding the arbitration clause, claims based on the noncompete clause could be heard in courts. A confidentiality clause carve-out was present in agreements where: (1) the CEO promised to keep certain information pertaining to the company and its activities private;⁸¹ (2) the parties agreed to arbitrate their disputes; and (3) the parties nevertheless reserved the right to bring confidentiality clause claims to court. Client nonsolicitation and employee nonsolicitation clauses contained promises by the CEO not to solicit clients or employees of the company for a certain period of time after leaving the firm. A nondisparagement clause contained a promise by the CEO not to make public comments disparaging the firm during or after termination of the employment relationship. Finally, the preliminary relief carve-out provided a statement that, notwithstanding the arbitration clause, a party can go to court to seek preliminary relief (such as a preliminary injunction). The preliminary relief carve-out may differ from the other types of carve-outs in the sense that these carve-outs may be inserted in aid of arbitration rather than as a statement that the parties desire courts instead of arbitration. But regardless of the motive for the carve-out, all carve-outs can tell us something about the circumstances in which contracting parties demand court services.

81. Importantly, these confidentiality clauses are not provisions stating that the parties agree to keep details about their future disputes private. Some of the arbitration clauses in CEO employment contracts did include those provisions, but they are not counted here.

The carve-out rates listed above are somewhat imperfect indicators of party preferences for carve-outs, however. Specifically, it is not always apparent from the data what fraction of the contracts containing both a particular type of clause and an agreement to arbitrate also state that disputes arising under the clause will be carved out for court resolution. For example, in the entire sample of CEO employment contracts, only thirty contained nondisparagement clause carve-outs. That seems like a small number of carve-outs, but it could be that relatively few contracts contain nondisparagement clauses in the first place. Unfortunately, O'Hara O'Connor, Martin, and Thomas did not code the data for the presence of all of these clauses, though they did code for the presence of confidentiality clauses and nonsolicitation clauses.⁸² A total of 418 of the contracts calling for arbitration also contained a confidentiality clause. Recall that 166 of these contracts carve out disputes involving a breach of that clause. Thus, 39.7% of the contracts with both confidentiality clauses and arbitration clauses carve-out these disputes for courts.⁸³ O'Hara O'Connor, Martin, and Thomas also coded the data for the presence of a nonsolicitation clause (these clauses could prohibit the solicitation of either employees or clients).⁸⁴ A total of 345 contracts with an arbitration clause contained such a contract, and 145 of those contracts carved out claims under either the employee or the client nonsolicitation provisions. Thus, 42% of the contracts with a nonsolicitation clause and an arbitration agreement carved out those issues for court resolution.⁸⁵

Note that these companies are carving out disputes involving clauses that help the company protect the value of its private information. This information helps give the company a competitive advantage, primarily through enhanced trademark and effective trade secrets. One advantage of arbitration is that it provides the parties with enhanced confidentiality because, unlike court proceedings, the arbitral proceedings are not a matter of public record.⁸⁶ When the underlying dispute is about the CEO diluting the value of the company's information, however, the parties may need to resort to courts to protect the information's value. Arbitrators have the authority to order injunctive relief,⁸⁷ but without the contempt power of the courts, an arbitrator's order may prove ineffective. Moreover, preliminary injunctions may be a necessary adjunct to such a proceeding, and

82. *See id.* at 169.

83. *Id.* at 168–69.

84. *Id.* at 169.

85. *Id.*

86. *E.g.*, Schmitz, *supra* note 13, at 1222–26.

87. *E.g.*, 2 BORN, *supra* note 15, at 2480–81; *see also, e.g.*, AAA COMMERCIAL ARBITRATION RULES, *supra* note 10, R-47(a) (“The arbitrator may grant any remedy or relief that the arbitrator deems just and equitable and within the scope of the agreement of the parties”); *id.* R-37(a) (“The arbitrator may take whatever interim measures he or she deems necessary, including injunctive relief”).

arbitration is not well suited to award such emergency relief.⁸⁸ Both arbitrators and courts can award damages for breach of an agreement. Valuing information is difficult, however, and proof problems and limited CEO assets can hinder effective compensation. In these circumstances, the parties seem to prefer courts to arbitration because they prefer more reliable recourse to equitable relief.

Finally, the data showed both a statistically significant increase in the use of arbitration clauses over time and a statistically significant increase in the use of carve-outs over time. In addition, the average number of carve-outs found in an arbitration clause increased during the time period studied.⁸⁹

B. *Technology Contracts*

Technology-related contracts provided a second type of contract from which to study carve-outs from arbitration. We gathered and coded contracts available on EDGAR that were filed with the SEC between July 2007 and July 2011. The authors searched the filings of companies classified by four-digit SIC codes (and company names) that indicated the filing company's classification as an IT-related business. Seven SIC codes were selected, which produced contracts from companies in radiotelephone communications (including wireless operators), telephone communications (including names like AT&T), data processing services, computer programming services, computer integrated systems design, computer processing and data services, and business services "not elsewhere classified" (including companies such as Yahoo!, eBay, and Zillow). Company filings were searched for "service agreement" and "commercial agreement." Obviously, non-IT documents were then filtered out (i.e. share purchase agreements, credit agreements, financial reports, shareholder proxy agreements, and leases). This left 141 contracts that took the form of service agreements, master service agreements, licensing agreements, and other similar agreements. Several contracts were essentially duplicate contracts where the same company had entered into the same agreement with multiple parties. Where the terms looked substantially similar, the sample excluded duplicates. After this filtering, a total of 120 contracts were coded for the analysis.

88. Drahozal & Ware, *supra* note 15, at 456–57. Note that the study did not code as provisional relief carve-outs arbitration clauses incorporating provider rules stating that pursuing provisional relief in court is not a waiver of the right to arbitrate. *E.g.*, AAA COMMERCIAL ARBITRATION RULES, *supra* note 10, R-52(a). Such rules differ from carve-outs because they do not exclude the arbitrators from jurisdiction over the matter.

89. O'Hara O'Connor et al., *supra* note 20, at 175. Interestingly, contracts involving firms headquartered in California had significantly fewer carve-outs per arbitration clause than did firms located elsewhere, *id.*, which likely stems from California courts' hostility to the use of carve-outs in employment contracts.

The coded contracts represented firms listed in all seven SIC code categories.⁹⁰ Although all contracts were filed between 2007 and 2011, they were executed between 1998 and 2011. However, the vast majority (90%) were executed between 2005 and 2011, and approximately 72% were entered into between 2007 and 2010.

A total of fifty-seven, or 47.5%, of the 120 technology contracts analyzed contained an arbitration clause. This rate was similar to the CEO employment contracts (51.5%) discussed above.⁹¹ The technology contracts contained comparatively fewer carve-out provisions, however. In total, twenty (35.1%) of the contracts with arbitration clauses carved out some actions or forms of relief for court resolution, as compared with 47% of CEO employment contracts and 97.7% of franchise contracts.⁹² Technology contract provisions carved out the types of claims shown in Table 2. The two most common types of carve-outs were for claims for injunctive relief (33.3% of arbitration clauses) and claims for breach of a confidentiality clause (17.5% of arbitration clauses).

Type of carve-out	# of contracts with carve-out	% of arbitration clauses with carve-out
Any carve-out	20	35.1%
Injunctive relief claims	19	33.3%
Confidentiality clause claims	10	17.5%
Claims for monies owed	3	5.3%
Noncompete clause claims	1	1.8%
Nonsolicitation clause claims	1	1.8%

The rate of incorporation of both arbitration clauses and carve-outs in the technology contracts varied by type of firm, as shown in Table 3. These rates also varied by the type of contract, as shown in Table 4. The variance,

90. The frequency of the types of firms in the sample is as follows:

SIC Number	Category	# of contracts
4812	Radiotelephone Communications	10
4813	Other Telephone Communications	21
7370	Computer Programming/Consulting	14
7371	Computer Programming Services	5
7373	Computer Integrated Systems Design	4
7374	Computer & Data Processing	15
7389	Business Services (NEC)	51
	TOTAL	120

91. See *supra* text accompanying note 79.

92. See *supra* Sections II.A., D.

especially the large variance across contract type, suggests possible differences in party bargaining power. The variance also suggests differences in the relative value of information, innovation, or other assets for which injunctive relief might be necessary, as well as possible differences in the portfolio of risks each type of contract entailed. More generally, these differences would reflect differences in performance incentives, dispute resolution costs, specification costs, bifurcation costs, or some combination thereof.

SIC category	% contracts with arbitration clauses	% of arbitration clauses with carve-out
Radiotelephone communications	60.0%	33.3%
Other telephone communications	43.0%	44.4%
Computer programming/consulting	35.7%	40.0%
Computer programming services	40.0%	50.0%
Computer integrated systems design	50.0%	50.0%
Computer & data processing	53.3%	25.0%
Business services (NEC)	49.0%	36.0%

Contract Type	# of contracts	% of contracts with arbitration clauses	% of arbitration clauses with carve-outs
Master Services	22	36.4%	75.0%
Service Agreements	36	44.4%	25.0%
Consulting Agreements	8	87.5%	0.0% ⁹³
Licensing Agreements	8	62.5%	60.0%
Communication Contracts	14	28.6%	25.0%
General Business Operations	19	47.4%	44.4%

Importantly, the technology contracts provide an opportunity to observe the contracting behavior of parties outside of the United States as well as those contracting across national borders. Before filtering out contracts without arbitration clauses, the authors categorized each contract into one

93. All of the consulting agreement contracts were executed between two companies located in China. None of the contracts entered into between two Chinese companies had any carve-outs.

of three groups:⁹⁴ contracts between two U.S. parties; contracts between two non-American parties from the same country; and contracts between companies located in two different countries (cross-border contracts). Most of the contracts involving two companies from the same country other than the United States were contracts between two companies located in China. Of the forty-three contracts in this category, thirty-six were executed by companies from China, two were executed by companies located in Vietnam, two by companies located in Mexico, one by companies located in the UK, one by companies located in Brazil, and one by companies located in Taiwan. Of the twenty-one cross-border contracts, sixteen of them involved a contracting party located in the United States.

Table 5 reports on the incorporation of arbitration clauses and carve-outs from arbitration in the contracts for each of the three party location categories:

	Both parties from United States	Both parties from same foreign country	Cross-border
% of contracts with arbitration clauses	35.7%	65.1%	42.9%
% of arbitration clause with carve-outs	65%	3.6%	66.7%

All but two of the “same country-foreign” contracts with arbitration clauses involved two companies located in China. The remaining two were contracts between parties located in Mexico and Brazil. The contract between two Mexican companies was the only contract in that group to carve anything out from arbitration. That contract contained a single carve-out for confidentiality-clause claims. Of the nine cross-border contracts with arbitration clauses, seven of the nine involved a contract with one

94. The frequency of each of the groups in the sample is as follows:

Location of Parties	# contracts	% of total technology contracts
Both companies U.S.	56	46.7%
Both companies located in same country—non-U.S.	43	35.8%
Companies located in two different countries (cross-border)	21	17.5%

party located in the United States. The other two contained no carve-out clauses. Of the seven contracts involving one U.S. party, six (85.7%) had carve-outs.

Arbitration clauses in technology contracts entered into between two U.S. parties and between one U.S. party and a party from another country included carve-outs for disputes as shown in Table 6.

Type of carve-out	# of contracts with carve-outs	% of arbitration clauses with carve-out
<i>Contracts between two U.S. parties</i>		
Any carve-out	13	65%
Injunctive relief claims	13	65%
Confidentiality clause claims	5	25%
Nonsolicitation clause claims	2	10%
Claims for monies owed	2	10%
<i>Contracts with one U.S. Party</i>		
Any carve-out	6	85.7%
Injunctive relief claims	6	85.7%
Confidentiality clause claims	4	57.1%
Claims to protect trademark	3	42.9%
Noncompete clause claims	1	14.3%
Claims for monies	1	14.3%

Surprisingly, in the contracts with two U.S. parties, the parties did not seem interested in specifically carving out disputes involving intellectual property claims, although the confidentiality and nonsolicitation clauses can help a company protect trade secrets. In this sense, they more closely resembled the CEO employment contracts than the franchise agreements. In addition, these parties were more likely to rely on preliminary relief and less likely to carve out the entire claim than was the case for CEO employment contracts. The authors lack an intuition for this difference beyond the possibility that the technology industry firms are relatively more concentrated in California, where, as discussed below, carving out claims can jeopardize the enforceability of the entire arbitration clause.

With the arbitration clauses in cross-border technology contracts, there is a small-sample problem preventing any firm conclusions. But note that the cross-border agreements were more likely to contain claims carve-outs as well as carve-outs specifically addressing the protection of intellectual property. One possibility for this difference, assuming it is a real one, is that parties do not worry about California courts' treatment of carve-outs in the context of international arbitration. In general, although California

courts often insist on imposing rules for arbitration that tend to hinder domestic arbitration, the rules are relaxed in the international context,⁹⁵ presumably in an effort to compete for international arbitration business.

Note that the presence of carve-outs in technology contracts varied dramatically according to the location of the parties. When the contract involved one or more parties located in the United States, carve-outs from arbitration were commonly present. Carve-outs in technology contracts involving a U.S. business occurred more frequently than they occurred in CEO employment contracts and less frequently than they occurred in franchise contracts.⁹⁶ When two parties located outside of the United States entered into technology contracts, regardless of whether those companies were located in the same country, only a single carve-out was present in a single contract. However, 86.7% (twenty-six of thirty) of the contracts involving foreign parties and containing arbitration clauses were contracts between two companies located in China.

The contracts with Chinese companies are instructive. Despite significant investment by the Chinese government in the development of intellectual property and other courts, the contracts indicated that parties remain reluctant to rely on such courts to resolve their claims. The findings serve as a reminder that court resolution of a claim can only add performance incentives if parties perceive the courts to be well functioning.⁹⁷ As discussed below in Part III, this finding suggests that it is particularly important for courts in the United States and elsewhere to develop useful rules, precedents, and procedures to be applied to claims involving the protection of information, innovation, and reputation.⁹⁸ These claims are less well handled via arbitration than are other commercial matters, so the value added by courts likely is higher.

Not surprisingly, the rate of the use of arbitration clauses is higher for cross-border contracts than for contracts entered into between two U.S. parties.⁹⁹ Note, however, that the incidence of carve-outs in contracts that

95. *E.g.*, CAL. CIV. PROC. CODE § 1297.351 (West 2014) (In international commercial conciliation “[t]he parties may appear in person or be represented or assisted by any person of their choice. A person assisting or representing a party need not be a member of the legal profession or licensed to practice law in California”).

96. *See supra* Sections II.A., D.

97. Of course, a remaining puzzle is why Chinese contracting parties do not instead opt for foreign courts. This reluctance might well stem from concerns that Chinese courts will not enforce foreign court judgments. *See* Arthur Anyuan Yuan, *Enforcing and Collecting Money Judgments in China From a U.S. Judgment Creditor’s Perspective*, 36 GEO. WASH. INT’L L. REV. 757, 758 (2004) (noting “notorious” difficulty of securing enforcement of foreign judgments in China).

98. *See infra* text accompanying notes 166–67.

99. *E.g.*, Theodore Eisenberg & Geoffrey P. Miller, *The Flight from Arbitration: An Empirical Study of Ex Ante Arbitration Clauses in the Contracts of Publicly Held Companies*, 56 DEPAUL L. REV. 335, 351 tbl. 3 (2007) (finding double the rate of arbitration clauses in transnational corporate transaction contracts than in domestic ones); *see also* 1 BORN, *supra* note 15, at 71.

had arbitration clauses was about the same in these two categories. This result is surprising given that court judgments are more difficult to enforce across borders than are arbitration awards.¹⁰⁰ Presumably the parties perceive that the performance incentives to court resolution of the matters are so much higher than arbitration that they offset both the reduced performance incentives and the increased dispute resolution costs associated with potential cross-border enforcement difficulties.

Finally, the rate of the use of arbitration clauses is highest for contracts entered into by two parties from the same country outside of the United States. Yet, in these cases the rate of carve-outs is dramatically lower. This suggests that, at least for foreign companies using the U.S. markets to raise capital, trust in the reliability of their domestic courts is significantly lower than it is for U.S. companies.

C. Joint Venture Agreements

We also examined the use of carve-outs in a small sample of joint venture agreements, both international and domestic, collected from SEC filings in 2008.¹⁰¹ Of the twenty-one domestic joint venture agreements in the sample, nine (42.9%) included arbitration clauses and one (4.8%) included an arbitration clause applicable only to some issues (a “carve-in”).¹⁰² Of the thirty-one international joint venture agreements in the sample, twenty-two (71.0%) included arbitration clauses.¹⁰³

As shown in Table 7, almost half (four of nine, or 44.4%) of the domestic joint venture agreements with arbitration clauses included a carve-out: three of nine (33.3%) permitted a party to go to court to seek provisional relief, and one of nine (11.1%) permitted a party to go to court to seek injunctive relief. As with the technology contracts discussed above, fewer of the international joint venture agreements with arbitration clauses (four of twenty,¹⁰⁴ or 20.0%) included carve-outs: two of twenty (10.0%) contained carve-outs for injunctive relief; one of twenty (5.0%) included a

100. See BÜHRING-UHLE, *supra* note 15, at 136.

101. The contracts previously were discussed in Drahozal & Ware, *supra* note 15, at 465–66.

102. Joint Venture Agreement Between Myohionow.com, LLC and Lakes Ohio Development, LLC ¶ 7.3 (Apr. 29, 2008) (copy on file with author) (providing that if any provision of agreement is declared invalid, the parties are unable to negotiate a substitute provision, and a party “considers on reasonable grounds that its commercial interests . . . are materially and adversely affected,” then “it may submit such matter to arbitration pursuant [to] rules set forth by the American Arbitration Association”).

103. The thirty-one international joint ventures consisted of thirteen joint ventures with no U.S. parties, fourteen with a U.S. party and at least one non-U.S. party, and four with missing information about party nationality but with the location of the venture itself outside the United States.

104. The text of the dispute resolution clause for two of the international joint venture agreements was redacted from the SEC filing. In both cases the clause was an arbitration clause, but in neither case was it possible to tell whether the clause included any carve-outs.

carve-out for claims seeking provisional relief; and one of twenty (5.0%) carved out claims seeking to protect joint venture intellectual property rights or trade secrets as well as trade secrets or corporate opportunities of one (but not the other) of the parties in a joint venture¹⁰⁵

Table 7. Carve-Outs in Domestic and International Joint Venture Agreements		
Type of carve-out	# of contracts with carve-out	% of arbitration clauses with carve-out
<i>Domestic Agreements</i>		
Any carve-out	4	44.4%
Provisional relief claims	3	33.3%
Injunctive relief claims	1	11.1%
<i>International Agreements</i>		
Any carve-out	4	20.0%
Provisional relief claims	1	5.0%
Injunctive relief claims	2	10.0%
IP, trade secrets, corp. opportunities	1	5.0%

Carve-outs are less common in international joint ventures involving at least one Chinese party, but the sample is not large enough for any sort of statistical testing. All thirteen of the contracts with at least one party from China included arbitration clauses, but only one of those (7.7%) used a carve-out. By comparison, three of the remaining nine (33.3%) international contracts with arbitration clauses but without Chinese parties used carve-outs.¹⁰⁶

D. Franchise Agreements

Consider also the use of carve-outs in franchise agreements. Franchise agreements differ from the contracts discussed in the sections above in several respects. First, franchise agreements are not individually negotiated. The franchise agreements studied were standard form contracts drafted by the franchisor.¹⁰⁷ Second, the sophistication of franchisees may vary widely. Some franchisees are inexperienced individuals running their first business. Other franchisees are large, publicly traded corporations.¹⁰⁸

To examine the use of carve-outs this study used two different samples

105. Joint Venture Agreement Between Tambala Food Products and Millennium Group Worldwide ¶ 14.2.2 (Nov. 12, 2007) (copy on file with author), available at <http://www.sec.gov/Archives/edgar/containers/fix300/1409327/000112178108000092/millenniumexhibit10four.htm>.

106. Six of these contracts had at least one U.S. party; two of those six used a carve-out.

107. Drahozal, *supra* note 18, at 722–23, 723 n.209.

108. *Id.* at 766.

of franchise agreements, both based on Entrepreneur Magazine's Franchise 500—an annual listing of top-ranked franchise opportunities.¹⁰⁹ The 2011 sample was derived from the top 100 franchises in 2011. The 1999 sample was derived from the top seventy-five franchise opportunities in 1999, and it tracked changes in the terms of those franchise agreements over time.¹¹⁰ For both samples, we gathered contracts for those franchises operating in the state of Minnesota. Any franchisor that grants a franchise right within Minnesota must file a copy of the company's standard franchise agreement with that state.¹¹¹

The 2011 sample consisted of eighty-six franchise contracts filed as of July 2011.¹¹² Forty-three of the eighty-six contracts contained arbitration clauses (50%), and of those forty-three, all but one carved out one or more claims or proceedings from arbitration and provided a right to the parties to instead proceed in court. Below is a list of types of carve-out provisions found in the 2011 sample:

Type of carve-out	# of contracts with carve-out	% of arbitration clauses with carve-out
Any carve-out	42	97.7%
Injunctive relief claims	41	95.3%
Claims to protect trademark	29	67.4%
Noncompete clause claims	17	39.5%
Confidentiality clause claims	13	30.2%
Nonsolicitation clause claims	8	18.6%
Claims to protect real property rights	5	11.6%
Claims for moneys owed	5	11.6%
Non-disparagement clause claims	2	4.6%

Most of these carve-outs were also found in the CEO employment contracts.¹¹³ Carve-outs to protect real property rights were found in franchise contracts where the franchisor agreed to lease commercial

109. *2011 Franchise 500 Rankings*, ENTREPRENEUR.COM, <http://www.entrepreneur.com/franchises/rankings/franchise500-115608/2011,-1.html> (last visited June 24, 2014).

110. This sample is an updated version of one previously used in Drahozal, *supra* note 18, at 722–24; *see also* Drahozal & Hylton, *supra* note 15, at 562; Drahozal & Wittrock, *supra* note 23, at 90.

111. These contracts are made available by the Minnesota Department of Commerce. *See Commerce Action and Regulatory Documents Search*, MINN. DEP'T OF COMMERCE, <https://www.cards.commerce.state.mn.us/CARDS/security/search.do> (last visited June 24, 2014).

112. The samples overlap to some degree: Of the eighty-six franchises in the 2011 sample, thirty-two also appear in the 1999 sample.

113. *See supra* Section II.A.

property from the owner and then sublease it to the franchisee to conduct franchise operations. Under the sublease arrangement, the franchisor reserved the right to enforce its rights to possession of the property in court.¹¹⁴ Carve-outs to collect monies owed simply provided that the franchisor could go to court to collect debts owed by the franchisee.

The 1999 sample consisted of sixty-seven franchises for which franchise agreements were available for all of the years studied: 1999, 2007, and 2013.¹¹⁵ The overall use of carve-outs is broadly consistent with the findings from the 2011 sample. Every franchise agreement with an arbitration clause, with the exception of one in 1999, included some form of carve-out. The relative frequency of the carve-outs was almost identical to the 2011 sample.

	# (%) of contracts with carve-out		
	1999	2007	2013
Any carve-out	30 of 31 (96.8%)	29 of 29 (100.0%)	31 of 31 (100.0%)
Injunctive relief claims	29 of 31 (93.5%)	28 of 29 (96.6%)	27 of 31 (81.7%)
Claims to protect trademark ¹¹⁶	21 of 31 (67.7%)	20 of 29 (69.9%)	22 of 31 (71.0%)
Provisional relief claims ¹¹⁷	17 of 31 (54.8%)	17 of 29 (58.6%)	19 of 31 (61.3%)
Noncompete clause claims	8 of 31 (25.8%)	12 of 29 (41.4%)	11 of 31 (35.5%)
Confidentiality clause claims	5 of 31 (16.1%)	11 of 29 (37.9%)	13 of 31 (41.9%)

114. For example, see Supercuts, Subway, Circle K, Snap Fitness, and Fantastic Sam's agreements (contracts on file with authors).

115. The original 1999 sample consisted of seventy-five franchises. Since then, seven of those franchises have either stopped doing business in Minnesota or stopped doing business altogether (through a merger or otherwise).

116. Consistent with the 2011 sample, franchise agreements in the 1999 sample were coded as including an injunctive relief carve-out whenever the arbitration clause carved out some form of injunctive relief, including preliminary injunctions and injunctive relief as to a particular type of claim. In addition, three arbitration clauses included language providing that injunctive relief was available under the usual standards for granting such relief, without specifically mentioning the forum. Again, consistent with the 2011 sample, these arbitration clauses were coded as including injunctive relief carve-outs. For both these reasons, the results reported here differ from the results reported in Drahozal & Wittrock, *supra* note 23, at 114–15.

117. Two arbitration clauses included language providing that preliminary injunctive relief was available under the usual standards for granting such relief, without specifically mentioning the forum. Again, consistent with the coding of the clauses for injunctive relief carve-outs, see *supra* note 116, these clauses were also coded as including carve-outs for provisional relief claims.

Claims to protect real property rights	9 of 31 (29.0%)	6 of 29 (20.7%)	3 of 31 (9.7%)
Claims for moneys owed	12 of 31 (38.7%)	9 of 29 (31.0%)	10 of 31 (32.3.0%)

The franchise agreements in the 1999 sample provided two additional insights. First, for franchisors, carve-outs are not a new phenomenon. They were widespread in the franchise agreements from 1999. Second, the use of some carve-outs has changed, albeit only slightly, over time. Limiting the sample to franchise agreements that used arbitration agreements throughout the period illustrates this change.

	# (%) of contracts with carve-out		
	1999	2007	2013
Injunctive relief claims ¹¹⁸	22 of 23 (95.7%)	22 of 23 (95.7%)	21 of 23 (91.3%)
Claims to protect trademark	15 of 23 (65.2%)	17 of 23 (73.9%)	18 of 23 (78.3%)
Provisional relief claims ¹¹⁹	13 of 23 (56.5%)	13 of 23 (56.5%)	14 of 23 (60.9%)
Noncompete clause claims	8 of 23 (34.8%)	11 of 23 (47.8%)	9 of 23 (39.1%)
Confidentiality clause claims	5 of 23 (21.7%)	10 of 23 (43.5%)	10 of 23 (43.5%)
Claims to protect real property rights	6 of 23 (26.1%)	5 of 23 (21.7%)	3 of 23 (13.0%)
Claims for moneys owed	8 of 23 (34.8%)	6 of 23 (26.1%)	8 of 23 (34.8%)

The use of carve-outs for trademark claims and claims for provisional relief—already among the most common types—increased somewhat over the period. By comparison, carve-outs for moneys owed and for real property claims decreased, at least to some extent, over the period.

With the exception of the carve-outs for monies owed, all of these carve-outs involve contract provisions designed to protect the franchisor's real property, intellectual property, or their rights to information, reputation, or innovation. The tradeoffs between litigation and arbitration here seem substantially similar to those found in the CEO employment contracts: arbitration can provide confidentiality to the parties, but when

118. *See supra* note 116.

119. *See supra* note 116.

the underlying dispute threatens to destroy information or other property value for the company, the parties seem to prefer litigation.¹²⁰ Unlike the CEO employment contracts, however, one additional motivation for the arbitration agreement is a desire to avoid class actions by franchisees.¹²¹ Note that the franchise contract carve-outs all seem to give the franchisor, rather than the franchisees, rights to proceed with litigation.¹²² Like the CEO employment contracts, these contracts tend to be formed between two U.S. parties. Although the CEO employment contracts likely are heavily negotiated on both sides,¹²³ often the franchise contracts are not mutually negotiated. This difference is somewhat apparent in the specific language used in the carve-out clauses, but it does not seem to significantly affect the types of carve-outs present in the agreements.

This study also separated the contracts in the 2011 sample into categories by type of franchise business for separate analysis. Categories included food, hospitality, education, exercise, cleaning, tools and automotive, and others. Arbitration rates as well as carve-out rates for each of these categories are shown in Table 11.

Industry	# contracts from industry	# (%) of arbitration clauses in contracts	# (%) of arbitration clauses with carve-outs
Food	24	13 or 54%	13 or 100%
Hospitality (Hotels)	8	0	-----
Education	4	2 or 50%	2 or 100%
Exercise	5	5 or 100%	5 or 100%
Cleaning	8	4 or 50%	4 or 100%
Tools/Automotive	10	7 or 70%	6 or 85.7%
Other	27	12 or 44.4%	12 or 100%

Note that the arbitration clause rate varied considerably (from 0% to 100%), but where arbitration clauses were present, at least one remedy or form of dispute was reserved for court resolution in all contracts but one. Rates of specific type of carve-out for each industry are shown in Table 12.

120. *See supra* Section II.A.

121. Drahozal & Wittrock, *supra* note 12, at 281–82.

122. Occasionally the contracts will include provisions that make this unilateral right to litigate more clear. For example, the Jiffy Lube franchise contract (on file with authors) empowers the franchisor to sue in court to collect monies owed, unless the franchisor counterclaims for breach of the franchise agreement, in which case the parties are to be sent back to arbitration.

123. *See* Thomas et al., *supra* note 74, at 960.

Type of carve-out	Food	Education	Exercise	Cleaning	Tools/ Auto	Other
Any carve-out	13	2	5	4	6	12
Injunctive relief	13 or 100%	2 or 100%	5 or 100%	4 or 100%	5 or 71.4%	12 or 100%
Trademark	10 or 76.9%	0	2 or 40%	4 or 100%	3 or 42.9%	10 or 83.3%
Noncompete Clause	6 or 46.1%	0	1 or 20%	3 or 75%	2 or 28.6%	5 or 41.7%
Confidentiality Clause	6 or 46.1%	0	0	0	1 or 14.3%	4 or 33.3%
Monies Owed	4 or 30.77%	0	0	0	1 or 14.3%	0
Nonsolicitation Clause	3 or 23%	0	0	3 or 75%	0	2 or 16.7%
Real Property	1 or 7.7%	0	1 or 20%	0	0	3 or 25%
Nondisparagement Clause	0	0	0	2 or 50%	0	0

The use of specific types of carve-outs from arbitration varies significantly by type of franchise. Because rights to information, innovation, and property are all best protected through injunctive relief, that carve-out alone might enable the franchisor to also protect its interest in the other categories. Differences in the other types of carve-outs therefore could reflect differences in the length of contracts or (in some cases) differences in the underlying contract. For example, if an agreement does not have a noncompete clause or confidentiality requirement, then there is no need to carve out supporting claims from arbitration. In the 1999 sample, however, all of the franchise agreements with an arbitration clause but no carve-out for non-compete clause claims nonetheless included a covenant not to compete in 2012. Likewise, all of the franchise agreements with an arbitration clause but without a carve-out for confidentiality-clause claims nonetheless included a contract provision imposing a duty of confidentiality on the franchisee. Thus, the absence of a carve-out was not due to the absence of a contractual duty.

E. *Mobile Wireless Services Contracts*

Finally, for comparison purposes, the authors examined the use of carve-outs in one type of consumer contract. Mobile wireless services contracts have been at the center of recent litigation over the use of arbitration clauses and class waivers,¹²⁴ but little work has been done to examine systematically the use of arbitration clauses (much less carve-outs) in those contracts.¹²⁵

The market for mobile wireless services consists of facilities-based operators—operators that “offer mobile voice, messaging, and/or data services using their own network facilities”¹²⁶—and mobile virtual network operators (MVNOs)—operators that “purchase[] mobile wireless services wholesale from facilities-based providers and resell[] the services to consumers.”¹²⁷ Four facilities-based operators operate nationwide: AT&T, Sprint/Nextel, T-Mobile, and Verizon Wireless.¹²⁸ The rest operate regionally or locally.¹²⁹ The largest MVNO is TracFone, which has more subscribers than all but the four nationwide facilities-based operators.¹³⁰ MVNOs may serve otherwise underserved market niches or provide extended services or geographic coverage for facilities-based operators.¹³¹

In February and March 2013, the authors collected consumer agreements from the web pages of the twelve leading facilities-based operators (all those that operate nationally or regionally) and the two largest MVNOs (TracFone and H2O Wireless) for which subscriber data are available.¹³² Because facilities-based operators often include the customers of their wholesale customers (i.e., MVNOs) in their subscriber data,¹³³ we report our findings for facilities-based operators separately from our findings for the MVNOs to avoid double-counting.

124. Most notably, in *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740 (2011).

125. For exceptions, see Linda J. Demaine & Deborah R. Hensler, “Volunteering” to Arbitrate Through Predispute Arbitration Clauses: *The Average Consumer’s Experience*, 67 L. & CONTEMP. PROBS. 55, 57 (2004) and Amy J. Schmitz, *Legislating in the Light: Considering Empirical Data in Crafting Arbitration Reforms*, 15 HARV. NEGOTIATION L. REV. 115, 120 (2010).

126. *In re* Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993, FCC Rcd. 11-103 (2011), at 30 [hereinafter Fifteenth Mobile Wireless Competition Report].

127. *Id.* at 35.

128. *Id.* at 7.

129. *See id.* at 31.

130. *Id.* at 36.

131. *Id.* at 35.

132. Market share data for the facilities-based operators is from Strategy Analytics. *Grading the Top 10 U.S. Carriers in the Third Quarter of 2012*, FIERCEWIRELESS (Nov. 26, 2012), <http://www.fiercewireless.com/special-reports/grading-top-10-us-carriers-third-quarter-2012>. Market share data for the two MVNOs is from the FCC. Fifteenth Mobile Wireless Competition Report, *supra* note 126, at 262 tbl.C-6 (reporting 14.4 million subscribers for TracFone and more than 300,000 subscribers for H2O Wireless/Locus Telecommunications).

133. *See* Fifteenth Mobile Wireless Competition Report, *supra* note 126, at 37.

Agreements from eleven of the twelve facilities-based operators, covering 99.9% of subscribers, included arbitration clauses.¹³⁴ Ten of the eleven contracts with arbitration clauses, covering 99.7% of subscribers subject to arbitration, carved out small claims from arbitration.¹³⁵ The one contract without a small claims carve-out (which covered 0.3% of subscribers) included, instead, a carve-out for collection actions. The only other carve-outs were in contracts used by very small companies. One had a carve-out for intellectual property claims, while another had a carve-out for indemnity claims.

134. In 2011, the FCC reported that the total number of facilities-based operators exceeded ninety, and that the companies “typically provide[d] service in a single geographical area, many of them rural areas.” *Id.* at 32. As of the first quarter of 2010, the total number of MVNOs ranged from forty-three to sixty-one, although little or no data were publicly available on the subscriber base of the MVNOs. *Id.* at 36–37. Information on the use of arbitration clauses for facilities-based operators or MVNOs is limited to those described above. Given that the largest mobile services providers use arbitration clauses, it is a fair statement that the substantial (if not vast) majority of their customers are subject to arbitration clauses. Given the lack of data for the smaller mobile services providers, it is not necessarily the case that most or all mobile services providers use arbitration clauses. *Cf.* Peter B. Rutledge & Christopher R. Drahozal, *Contract and Choice*, 2013 BYU L. REV. 1, 18 (finding that most credit card issuers do not use arbitration clauses).

135. Small claims carve-outs also are widely used in credit card agreements. *See* Rutledge & Drahozal, *supra* note 134, at 21–22. Rutledge and Drahozal describe the use of carve-outs in credit card agreements as follows:

Far and away the most common carve-out in credit card arbitration clauses is for small claims (defined either by the dollar amount sought or by the claims being brought in small claims court). Of the issuers studied, thirty-two (of forty-seven, or 68.1%) excluded small claims from arbitration. Most of the agreements that did not exclude small claims were from small issuers (the fifteen issuers not including a small claims carve-out comprised only 1.6% of credit card loans outstanding, while the thirty-two including a small claims carve-out comprised 98.4% of credit card loans outstanding).

. . . .

Relatedly, five issuers (of forty-seven, or 10.6%; but 51.4% of credit card loans outstanding) excluded debt collection claims from arbitration. . . .

Other types of carve-outs are less common in credit card arbitration clauses. Nine issuers (of forty-seven, or 19.1%; 3.8% of credit card loans outstanding) excluded from arbitration claims for interim relief, such as preliminary injunctions and attachments. Twelve issuers (of forty-seven, or 25.5%; 11.2% of credit card loans outstanding) excluded repossession and other self-help remedies, while six issuers (of forty-seven, or 12.8%; 3.6% of credit card loans outstanding) excluded claims in bankruptcy.

Id. at 21–23; *see also* Consumer Fin. Prot. Bureau, *Arbitration Study Preliminary Results: Section 1028(a) Study Results to Date* 32–33 & tbl.4 (Dec. 12, 2013), http://www.consumerfinance.gov/f/201312_cfpb_arbitration-study-preliminary-results.pdf (presenting data on carve-outs for small claims).

Of the ten contracts with small claims carve-outs, four of ten (40.0%) covering 6.6% of subscribers applied to consumer small claims only. The remaining six (60.0%), which covered 93.4% of subscribers, carved out small claims brought by either consumers or the service providers. The carve-out for collection actions is very similar to a small claims carve-out for business claims only, to the extent the collection actions are brought in small claims court.

	# (%) of arbitration clauses with carve-outs	% of subscribers
<i>Facilities-Based Operators</i>		
Any carve-out	11 of 11 (100.0%)	100.0%
Small claims	10 of 11 (90.9%)	99.7%
Collection actions	1 of 11 (9.1%)	0.3%
<i>Mobile Virtual Network Operators (MVNOs)</i>		
Any carve-out	2 of 2 (100.0%)	100.0%
Small claims and/or collection actions	1 of 2 (50.0%)	2.0%
Claims for unauthorized sale, export, or tampering with equipment	1 of 2 (50.0%)	98.0%

By comparison, customer agreements from both MVNOs also included arbitration clauses. The TracFone agreement included a carve-out “for claims concerning the unauthorized sale, export, alteration and/or tampering of your TracFone, its software, the service and/or PIN numbers.”¹³⁶ One version of the H2O Wireless agreement included a small claims carve-out for both the service provider and the customer,¹³⁷ while the other included a small claims carve-out for the customer and a carve-out for collection actions.¹³⁸

Both the American Arbitration Association (through its Consumer Due Process Protocol) and JAMS (through its Minimum Standards of Procedural Fairness) require businesses to permit consumers to go to small claims court in lieu of arbitration.¹³⁹ As such, it is difficult to draw any

136. TRACFONE WIRELESS, INC., TERMS AND CONDITIONS OF SERVICE ¶ 23 (June 24, 2011) (copy on file with authors).

137. H2O WIRELESS, TERMS AND CONDITIONS (Feb. 2012) (copy on file with authors).

138. *Id.*

139. AM. ARBITRATION ASS'N, CONSUMER DUE PROCESS PROTOCOL: STATEMENT OF PRINCIPLES OF THE NATIONAL CONSUMER DISPUTES ADVISORY COMMITTEE, at Principle 5 (1998); JAMS POLICY

inferences about business or consumer behavior from the use of small claims carve-outs.¹⁴⁰ On the other hand, the fact that a majority of contracts representing the vast majority of customers also provide the service provider with the right to proceed in court with small claims suggests a possible cost-cutting motivation. In any event, other carve-outs appear to be much less common in contracts with consumers than in contracts with other businesses.

III. IMPLICATIONS

The analysis and empirical findings of this study suggest a number of possible implications for future scholarship and public policy related to both arbitration and courts. This Part discusses the implications of the analysis and findings for the following: (1) the contractual procedure scholarship; (2) the continuing role of courts in resolving business disputes; (3) the proper role of the unconscionability doctrine as applied to carve-outs from arbitration clauses; and (4) the application of severability doctrines in policing arbitration clauses more generally.

A. Procedural Unbundling and Contractual Procedure

The rapidly growing literature on contractual procedure analyzes unbundled or à la carte procedures.¹⁴¹ Much of the literature has focused on the theoretical and normative implications of contracting for unbundled procedures. Some commentators have identified a range of benefits that sophisticated parties might obtain with unbundled procedure.¹⁴² Others have highlighted potential dangers of unbundling for the enforcement of legal norms and the legitimacy of the adjudication process.¹⁴³ As Professor

ON CONSUMER ARBITRATION PURSUANT TO PRE-DISPUTE CLAUSES: MINIMUM STANDARDS OF PROCEDURAL FAIRNESS ¶ 1(B) (2009).

140. Moreover, the American Arbitration Association has reported that “few consumers exercise their right to have their matters heard in small claims court rather than in AAA consumer arbitration.” FEDERAL TRADE COMM’N, REPAIRING A BROKEN SYSTEM: PROTECTING CONSUMERS IN DEBT COLLECTION LITIGATION AND ARBITRATION 44 & n.211 (July 2010), available at <http://www.ftc.gov/sites/default/files/documents/reports/federal-trade-commission-bureau-consumer-protection-staff-report-repairing-broken-system-protecting/debtcollectionreport.pdf>.

141. See *supra* text accompanying note 17.

142. Kapeliuk & Klement, *supra* note 17, at 1483–84 (arguing that “*ex ante*, [the parties] can gain substantial advantages from modified rules both before and after the dispute emerges,” such as “reduc[ing] strategic and opportunistic behavior and litigation costs should a dispute arise,” “shap[ing] the parties’ *ex ante* substantive and procedural behavior,” and “creating information revelation mechanisms”).

143. Bone, *supra* note 17, at 1397 (arguing that “party rule-making is most problematic when it alters procedures and rules designed to frame, guide, or incentivize” the core of the adjudicatory process: “a commitment to a mode of reasoning that engages general principle and case-specific facts in an effort to reach reflective equilibrium”); Dodge, *supra* note 17, at 729 (contending that contractual procedure “has the capacity to reshape not only the role of the private right of action

David Hoffman states, the “scholarship has generally proceeded to work out ever-more-sophisticated theoretical frameworks to govern the appropriate relationship between private and public procedural rulemaking.”¹⁴⁴

As noted above, however, the available empirical evidence suggests that detailed provisions customizing procedural rules are generally quite rare in contracts between sophisticated parties. In samples of corporate contracts and credit card agreements, Professor Hoffman found “literally only a handful of contracts . . . in which parties expect the court to impose their own procedural rules.”¹⁴⁵ Moreover, even though one might expect a greater degree of procedural customization in arbitration clauses,¹⁴⁶ relatively little customization is found, at least in contracts between sophisticated parties.¹⁴⁷ Thus, O’Hara O’Connor, Martin, and Thomas found that only a very small percentage of arbitration clauses in CEO employment contracts contained customized terms.¹⁴⁸ To be sure, parties commonly chose an arbitral forum, an arbitration provider,¹⁴⁹ and applicable, off-the-rack procedural rules promulgated by the provider, all of which have implications for the governing rules applied to their dispute resolution proceedings. However, they did almost nothing to change the procedural rules that would apply by default in these fora, the subject of much of the literature on customized procedure.¹⁵⁰ For example, less than one percent of the contracts with arbitration clauses addressed the parties’ right to appeal the arbitrator’s decision to courts, only two percent addressed permitted testimony in the arbitration hearing, four percent provided time limits for demanding arbitration, and six percent addressed discovery.¹⁵¹

Several reasons might explain this surprising rarity of *ex ante* à la carte procedures. First, individualized unbundling could interfere with

between contracting parties but also the broad swath of statutory, constitutional, and common law obligations that rely upon [procedure] as a primary mechanism of enforcement”).

144. Hoffman, *supra* note 20, at 393.

145. *Id.* at 429.

146. For example, given that the authority of arbitrators depends on the parties’ agreement, one might expect arbitrators to be more likely to apply contractually-specified procedures than judges.

147. By comparison, in standard form contracts between businesses and consumers, provisions modifying arbitral procedures are more common, although again the frequency varies widely depending on the type of contract. *E.g.*, Rutledge & Drahozal, *supra* note 134, at 21–49. Moreover, some franchise agreements also contain provisions customizing procedure as well as the sorts of carve-outs studied here. Drahozal & Wittrock, *supra* note 23, at 99–114.

148. O’Hara O’Connor et al., *supra* note 20, at 166.

149. Of those choosing an arbitration provider, however, more than 90% of the contracts studied chose the AAA. *Id.* at 163.

150. *Id.* at 166. One might therefore think of this customization as the arbitration equivalent of a simple choice-of-court clause, where parties might choose a specific forum because in general they approve the procedures applied there by default.

151. *Id.*

cooperative mindsets because such efforts signal to the other party that one anticipates future disputes.¹⁵² Alternatively, unbundling may not occur because the lawyers drafting contracts are acting out of habit rather than pursuing optimization goals (or for other reasons contracts are “sticky”).¹⁵³ By one account, unbundling is a type of innovation, and innovation typically happens only through shocks to a system, which have not yet occurred.¹⁵⁴ Under this explanation, the potential benefits of unbundling have not yet been fully realized by legal practitioners.

A third possibility is that the individualized, *ex ante* procedural unbundling focused on in the literature could be prohibitively costly for most parties. Drafting costs could inhibit the parties, but adding a sentence or even a paragraph to a high-value contract should not prove preclusive. Instead, procedural customization could prove costly because of forecasting problems. Specifically, parties face a variety of different risks in their contractual relationships that could turn into disputes. Counterparties might not perform as they promise; they might perform, but in a negligent manner; they might cause a personal or financial injury to others in the course of performance; or they might perform perfectly, but steal a party’s personal property, intellectual property, or other proprietary information. These are just a few of the possible risks.

If these risks materialize, they could lead to disputes involving many possible claims including breach of contract, negligence, trespass, conversion, actions for indemnity, misuse of intellectual property, etc. Given this diversity of possible risks and their accompanying legal claims, the optimal procedures for one potential dispute might well not prove optimal for others.¹⁵⁵ Forecasting and then articulating the best possible procedures for each of these disputes could prove too costly, especially when the parties must agree that those procedures mutually benefit them. Support for this possibility can be found in the fact that procedural customization appears to be more common in the adhesion contract

152. See Theodore Eisenberg et al., *Mandatory Arbitration for Customers but Not for Peers: A Study of Arbitration Clauses in Consumer and Non-Consumer Contracts*, 92 JUDICATURE 118, 122 (2008); Kathryn E. Spier, *Incomplete Contracts and Signaling*, 23 RAND J. ECON. 432, 432 (1992). See generally Robert H. Gertner & Geoffrey P. Miller, *Settlement Escrows*, 24 J. LEGAL STUD. 87, 119 (1995) (suggesting that mentioning dispute resolution procedures during contract negotiations can signal that a breach of contract claim is likely).

153. See, e.g., MITU GULATI & ROBERT E. SCOTT, *THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN* 33–34 (2013).

154. Hoffman, *supra* note 20, at 425–28.

155. Others have noted this potential difficulty in the context of customized procedure, and also more generally. Moffitt, *supra* note 17, at 484 (“The transaction costs involved in the search for potential efficiency may, in certain contexts, outweigh the potential benefits that might derive from customization.”); see Karen Eggleston et al., *The Design and Interpretation of Contracts: Why Complexity Matters*, 95 NW. U. L. REV. 91, 91–92 (2000) (stating that complex contracts will often be left incomplete because of the transactions costs of covering every contingency).

context,¹⁵⁶ where the drafter can spread drafting costs across many contracts, and where the specific provisions need not be subject to individual bargaining.

We think the third explanation, that contract customization is limited by forecasting costs, has more merit than the first two theories. If signaling or sticky-contracts-awaiting-system-shock theories explain the lack of procedural customization, then one should not expect any routine contractual customization of dispute resolution. In fact, however, as this Article has shown, carve-outs also provide a means by which parties contract for unbundled procedure, and carve-outs are common in at least some types of contracts between sophisticated parties. This form of customization enables the parties to customize according to particular performance risks, which appears to better enable the parties to capture performance incentives relative to specification costs.

By unbundling potential claims and remedies, parties can then more effectively choose a default bundle of court procedures to treat some contractual risks while choosing a default bundle of arbitration procedures to treat others. This customization enables the parties to pick and choose the specific claims and remedies that are appropriately resolved in each venue. Moreover, by separating out some claims and remedies, this customization enables the parties to more carefully calibrate the fit between a chosen venue and the disputes it must handle.

Despite the potential signaling effects of focusing on disputes, customization of claims and remedies does occur.¹⁵⁷ Moreover, prior habits of binary choice or court default do not seem to constrain the parties from this type of customization. Instead, the parties unbundle claims and remedies because it enables them to separate out different types of contract risks for differing protection mechanisms. This type of tailoring is easier to forecast and cheaper to incorporate than the customization treated in the contractual procedure literature to date.¹⁵⁸ Indeed, claim and remedy customization might make other types of contractual customization more feasible. This is because unbundling the differing risks makes it cheaper to customize the procedure that would apply for that specific category of risks

156. See, e.g., Demaine & Hensler, *supra* note 125, at 64–72; Christopher R. Drahozal & Peter B. Rutledge, *Contract and Procedure*, 94 MARQ. L. REV. 1103, 1117 (2011); Rutledge & Drahozal, *supra* note 134, at 37–50.

157. Although claim and remedy customization, through carve-outs (or carve-ins), could signal a different type of consideration than specific procedural rule customization, in both contexts the negotiations entail fine-tuning the procedures that will apply in a given setting. Indeed, carve-outs could be viewed with more suspicion by counterparties, because unlike the situation where a given set of customized procedural rules would apply to both parties' claims, carve-outs often have the effect of causing one party's claims to be treated differently than at least some of the other party's claims. If signaling concerns do not work to defeat the negotiation of carve-outs, they are probably even less likely to work to defeat the negotiation of specific procedural rules.

158. See *supra* Sections I.B.–C.

depending on whether the claim is being handled in courts or arbitration. Nevertheless, the first cut at contractual customization should be, and apparently is, the unbundling of claims and remedies.

Thus, procedural customization is an empirical reality, albeit not in the form most commonly believed. The scholarship should readjust its focus accordingly.¹⁵⁹ More generally, this Article's analysis suggests that the contractual procedure literature should focus more on the costs and benefits of customized procedure. Our model helps identify the following key costs and benefits: the performance incentives (or costs) to the parties; the increase or decrease in process costs from the customization; and the specification costs of drafting and negotiating a customized procedure. Particularly important for the latter appears to be the difficulty of anticipating the types of disputes and claims for which the parties might, *ex ante*, agree to more detailed procedures.

B. *The Continued Necessity of Courts?*

Carve-outs also provide information on when sophisticated parties view courts as providing value. All types of contracts studied showed contracting parties regularly used both arbitration clauses and carve-outs from arbitration.¹⁶⁰ This fact suggests that parties demand both arbitration and courts in a broad variety of contexts. Given that contractual relationships tend to involve multiple but differing performance risks, it is not surprising that parties might prefer to use courts to address some of those risks but arbitration to address others. The arbitration literature has identified some circumstances where parties might prefer courts to arbitration.¹⁶¹ For example, scholars have previously noted that parties often prefer courts to arbitration for "bet-the-company" cases and cases in which they may need to obtain provisional relief.¹⁶² Consistent with that literature, franchise contracts carve out trademark disputes (potentially a "bet-the-company" dispute for a franchisor, as well as one in which provisional relief might be required).¹⁶³ Likewise, a common carve-out is for collection actions (or for moneys owed). In such actions the law and facts are likely to be relatively clear, and arbitration may do little more than

159. See Hoffman, *supra* note 20, at 434 ("Obviously, the ability to choose arbitration for particular types of disputes should complicate our models of the background rule against which parties' silence on procedural terms should be analyzed.").

160. See *supra* Part II.

161. Christopher R. Drahozal, *Why Arbitrate? Substantive Versus Procedural Theories of Private Judging*, 22 AM. REV. INT'L ARB. 163, 177-79 (2011); Drahozal & Ware, *supra* note 15, at 453-57; Noyes, *supra* note 17, at 586-89, 591-92.

162. Scott H. Blackman & Rebecca M. McNeill, *Alternative Dispute Resolution in Commercial Intellectual Property Disputes*, 47 AM. U. L. REV. 1709, 1711 (1998); Drahozal & Wittrock, *supra* note 23, at 79; W. Mark C. Weidemaier, *Disputing Boilerplate*, 82 TEMP. L. REV. 1, 14-15 n.83 (2009).

163. Drahozal, *supra* note 18, at 739; Drahozal & Wittrock, *supra* note 23, at 79-80.

add another procedural step before a party can take the necessary legal steps to collect a debt.¹⁶⁴

But this study enables a broader consideration of the types of claims where parties are likely to consistently rely on courts for enforcement. Some argue that there are entire categories of commercial disputes that no longer get resolved in courts because private parties prefer arbitration.¹⁶⁵ However, even in situations where parties routinely refer matters to arbitration, the contracts we analyzed suggest that they nevertheless continue to prefer courts as a mechanism for protecting information, innovation, reputation, and property.¹⁶⁶ If so, then courts should focus on providing the best possible substantive and procedural rules for the resolution of these types of disputes. That is the best way to provide value to private parties. This focus for court systems is nontrivial because the fraction of value in commercial exchange attributable to innovation and information is very significant (perhaps one half or more), and that fraction appears to be growing over time.¹⁶⁷

Consider, for example, court treatment of remedies available for breach of contract. One possible implication of the carve-out studies is that some parties conclude that courts can more efficiently and effectively resolve disputes involving requests for injunctive relief.¹⁶⁸ Injunctive relief can take multiple forms, with some forms more valuable to parties attempting to protect information and innovation than others. Because injunctive relief is equitable, however, U.S. courts are not always willing to provide such relief if other remedies are available.¹⁶⁹ This principle limits the granting of specific performance in lieu of monetary damages, and there is some evidence that this limitation is problematic for some contracting parties.

Significant controversy surrounds the question of whether courts should be more willing to order specific performance. The traditional common

164. Stephanie Francis Ward, *They Dun Them Wrong*, A.B.A. J., July 2008, at 16, 18 (“If the consumer is not going to pay the arbitration award, you have to take them to court anyway” (quoting Robert Markoff, President of the National Association of Retail Collection Attorneys)).

165. See, e.g., Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code’s Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1771–72 (1996); Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724, 1724 (2001).

166. For an expanded version of the argument in this Section, see Erin O’Hara O’Connor & Christopher R. Drahozal, *The Essential Role of Courts for Supporting Innovation*, 92 TEX. L. REV. (forthcoming 2014).

167. See, e.g., Jean Raymond Homere, *Intellectual Property Rights Can Help Stimulate the Economic Development of Least Developed Countries*, 27 COLUM. J.L. & ARTS 277, 281 (2004) (noting that IP assets alone account for 40% of U.S. corporate asset net value and over 33% of European company asset value).

168. Or, if arbitration is better at preserving the parties’ relationship, parties may be more willing to carve out types of disputes that are more likely to arise after that relationship is at an end.

169. DOUGLAS LAYCOCK, *MODERN AMERICAN REMEDIES: CASES AND MATERIALS* 380 (4th ed. 2010) (noting the general principle that “equity will not act if there is an adequate remedy at law”).

law rule is that courts will award specific performance only when damages would be inadequate,¹⁷⁰ and, even then, not in the context of personal services.¹⁷¹ On the other hand, courts in civil law countries are less reluctant to order specific performance,¹⁷² and there is evidence that the traditional common law rule has eroded in at least some American courts.¹⁷³ Scholars debate the policy merits of specific performance, with powerful arguments proffered on both sides.¹⁷⁴ In the meantime, behavioral scholars have demonstrated that average Americans tend to think specific performance is an appropriate, even preferred, remedy for breach of contract.¹⁷⁵

In a number of contexts, sophisticated parties seem to prefer specific performance as the most effective means to protect the value of their exchange. A recent empirical study conducted by Eisenberg and Miller showed that contracting parties commonly incorporate into their documents language designed to enhance the likelihood of obtaining an order for specific performance in the event of breach.¹⁷⁶ Specifically, their review of more than 2,300 contracts filed with the SEC in 2002 found that 31.5% of all contracts attempted to provide for specific performance as a remedy, with such provisions found in 57.8% of employment contracts and 53.4% of merger agreements.¹⁷⁷ Interestingly, however, they found that parties were more, rather than less, likely to attempt to contract for specific performance when they opted for their disputes to be resolved in arbitration.¹⁷⁸ Unfortunately, Eisenberg and Miller did not code for the

170. See, e.g., Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351, 354 (1978); Michael J. Sechler, Note, *Supply Versus Demand for Efficient Legal Rules: Evidence from Early English "Contract" Law and the Rise of Assumpsit*, 73 U. PITT. L. REV. 161, 170 (2011) (noting the strict rules for granting specific performance in actions of assumpsit).

171. See, e.g., *Jetborne Int'l, Inc. v. Cohan*, 584 So. 2d 176, 177 (Fla. Dist. Ct. App. 1991); RESTATEMENT (SECOND) OF CONTRACTS § 367 (1981).

172. Theodore Eisenberg & Geoffrey P. Miller, *Damages Versus Specific Performance: Lessons from Commercial Contracts* 15 (N.Y. Univ. Sch. of Law, Law & Econ. Research Paper Series, Working Paper No. 13-09, 2013), available at <http://ssrn.com/abstract=2241654>.

173. See *id.* at 16–17.

174. For examples of arguments in defense of the traditional rule, see Ian Ayres & Kristin Madison, *Threatening Inefficient Performance of Injunctions and Contracts*, 148 U. PA. L. REV. 45 (1999); Edward Yorio, *In Defense of Money Damages for Breach of Contract*, 82 COLUM. L. REV. 1365 (1982); Timothy J. Muris, Comment, *The Costs of Freely Granting Specific Performance*, 1982 DUKE L.J. 1053. For examples of arguments in favor of liberal granting of specific performance, see Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1 (1989); Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271 (1979); Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341 (1984).

175. Tess Wilkinson-Ryan & Jonathan Baron, *Moral Judgment and Moral Heuristics in Breach of Contract*, 6 J. EMPIRICAL LEGAL STUD. 405, 412, 420 (2009).

176. Eisenberg & Miller, *supra* note 172, at 5–6.

177. *Id.* at 35 tbl.3.

178. *Id.* at 38 & tbl.7.

presence of carve-outs in the arbitration clauses.¹⁷⁹ Parties seeking specific performance as a remedy for some claims might in fact designate courts for the resolution of those claims by placing carve-outs in their arbitration clauses. Alternatively, parties seeking specific performance might opt for arbitration rather than courts out of fear that courts are less likely than arbitrators to grant specific performance. If the latter explains the clauses, then courts might better serve party needs by announcing a clear willingness to order specific performance when parties contract for the remedy.¹⁸⁰ And, in any event, the Eisenberg and Miller findings help show the importance of accounting for contractual carve-outs.

Some scholars have noted a difference between common law and civil law countries regarding court ability and willingness to grant equitable relief more generally, as well as court willingness to exercise contempt powers.¹⁸¹ In civil law countries, where courts are not thought to have any inherent equitable powers, such authority must be granted by statute and may therefore be weaker.¹⁸² And even with an ability to coerce parties to comply with court orders, judges in countries where contempt authority is the exception rather than the rule may be relatively less willing than judges in the United States to use conferred contempt powers. Given the types of claims that U.S. parties are carving out from arbitration, the availability of equitable relief seems to create significant value for private parties.

A remaining question, which is too broad to adequately address here, is whether legal reforms should include the creation of specialized courts to handle claims involving information and innovation. Relatedly, states could experiment with lodging these claims in their business courts, which should have jurisdiction over most business contract disputes in any event.¹⁸³ Specialized courts might better serve party needs than courts of

179. O'Hara O'Connor & Drahozal, *supra* note 166 (manuscript at 21).

180. To be clear, however, the use of carve-outs does not provide evidence that parties prefer juries to arbitration, a possibility suggested by Eisenberg and Miller. See Theodore Eisenberg & Geoffrey P. Miller, *Do Juries Add Value? Evidence from an Empirical Study of Jury Trial Waiver Clauses in Large Corporate Contracts*, 4 J. EMPIRICAL LEGAL STUD. 539, 587 (2007). The most common types of claims that parties carve out of arbitration clauses either involve injunctive relief (including injunctions to enforce trademarks, covenants not to compete, and confidentiality agreements) or the use of specialized court procedures (collection actions and eviction actions), in none of which is a jury likely to play a role. This Article does not argue that juries never provide value to sophisticated parties in resolving their disputes. But it finds little evidence of such value in the provisions studied here.

181. JOHN OWEN HALEY, *AUTHORITY WITHOUT POWER: LAW AND THE JAPANESE PARADOX* 118 (1991); JOHN HENRY MERRYMAN, *THE CIVIL LAW TRADITION: AN INTRODUCTION TO THE LEGAL SYSTEMS OF WESTERN EUROPE AND LATIN AMERICA* 49, 55 (2d ed. 1985).

182. See, e.g., Robert S. Barker, *Judicial Review in Costa Rica: Evolution and Recent Developments*, 7 SW. J.L. & TRADE AMERICAS 267, 275 (2000).

183. See Christopher R. Drahozal, *Business Courts and the Future of Arbitration*, 10 CARDOZO J. CONFLICT RESOL. 491, 495–96 (2009) (discussing common jurisdictional grants in business court statutes).

general jurisdiction because the parties can more effectively rely on expert decision makers and potentially streamlined proceedings. Inevitably, such determinations would critically involve matters outside the scope of this Article's analysis, but this study does have implications for court reforms.

Of course, our analysis implicitly assumes both that social welfare is equivalent to private welfare in these contexts and that courts might ever be motivated to promote either private or social welfare. As to the first point, if sophisticated parties transact in a market context without significant third-party effects, then private and social welfare should converge. Where parties are unsophisticated or where third parties are hurt by party efforts to protect information and innovation, then this Article's analysis begins, rather than ends, the court reform discussion. As for the motivation of courts, U.S. courts considering reforms at least sometimes account for both efficient dispute resolution and party preferences.¹⁸⁴ Where those motivations are present, the findings reported here can provide helpful insights.

Finally, our findings have implications for the literature on economic development. Many scholars have noted the importance of strong courts and legal systems as factors that impact a nation's ability to attract investment opportunities.¹⁸⁵ Some scholars argue that a state's legal rules must protect private arrangements, through property and contract rights,¹⁸⁶

184. See Erin O'Hara O'Connor & Peter B. Rutledge, *Arbitration, the Law Market, and the Law of Lawyering* 14 (Vanderbilt Univ. Law Sch. Law & Econ., Working Paper No. 13-33, 2013), available at <http://ssrn.com/abstract=2349674> (discussing this dynamic in the context of the creation of business courts within the United States).

185. See, e.g., Charles W. Cookson II, *Long-Term Direct Investment in Brazil*, 35 U. MIAMI INTER-AM. L. REV. 345, 358 (2004) (noting importance of effective legal system for a nation's ability to attract foreign direct investment); Susan D. Franck, *Foreign Direct Investment, Investment Treaty Arbitration, and the Rule of Law*, 19 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 337, 340 (2007) (noting that "while investment treaty arbitration may not directly trigger investment, the availability of this dispute resolution mechanism is a factor in an overall decisional matrix"); Rumu Sarkar, *The Legal Implications of Financial Sector Reform in Emerging Capital Markets*, 13 AM. U. INT'L L. REV. 705, 721-22 (1998) ("The 'menu' of expectations that a foreign investor has in evaluating investment opportunities in a particular developing country is quite predictable. The criteria include . . . a legal system that provides adequate redress for conflicts or disputes."); David Hindman, Note, *The Effect of Intellectual Property Regimes on Foreign Investments in Developing Economies*, 23 ARIZ. J. INT'L & COMP. L. 467, 473 (2006) ("The attraction of sizable capital investment necessary for economic growth requires confidence that there will be predictable answers to key legal questions and that business disputes will be resolved promptly and fairly."); David F. Clossey & Jere R. Thomson, *A Global Law Firm Operating in a Global Market: Jones Day*, METROPOLITAN CORP. COUNS., May 2004, at 9, available at <http://www.metrocorpocounsel.com/pdf/2004/May/09.pdf> ("All in all, not only Russian counterparties, but also the Russian government, are recognizing the importance of the rule of law in attracting foreign investment.").

186. See, e.g., Ibrahim F. I. Shihata, *Judicial Reform in Developing Countries and the Role of the World Bank*, in JUDICIAL REFORM IN LATIN AMERICA AND THE CARIBBEAN: PROCEEDINGS OF A WORLD BANK CONFERENCE 219, 220 (Malcolm Rowat et al. eds., 1995).

and that those rules must be considered stable, through the development of stare decisis,¹⁸⁷ long-term commitments to international investment treaties,¹⁸⁸ or otherwise. In addition, the judiciary must be independent of the other branches of government¹⁸⁹ and sufficiently well funded to attract high quality judges who can expeditiously resolve disputes.¹⁹⁰

However, not all agree that this judicial investment is entirely essential. For example, Professor Tom Ginsburg has noted that third-party dispute resolution can facilitate investment by “substitut[ing] for poor institutional environments.”¹⁹¹ Other scholars have argued that nations can bypass decades of court and law reform efforts if they can credibly commit to enforcing arbitration clauses and arbitrator awards.¹⁹² The fact that more than 145 nations have signed the New York Convention,¹⁹³ which obligates states to enforce arbitration clauses and arbitral awards,¹⁹⁴ supports this emphasis on private arbitration as a substitute for ineffective domestic courts and legal systems. Given common scholarly claims that the vast majority of parties to international contracts prefer to arbitrate disputes,¹⁹⁵ it seems possible that at least international investment can easily thrive without strong courts.¹⁹⁶

187. See Cookson, *supra* note 185, at 351–52.

188. See, e.g., W. Michael Reisman & Robert D. Sloane, *Indirect Expropriation and its Valuation in the BIT Generation*, 74 BRIT. Y.B. INT’L L. 115, 115–16 (2003).

189. See Shihata, *supra* note 186, at 220.

190. See *id.*

191. Tom Ginsburg, *International Substitutes for Domestic Institutions: Bilateral Investment Treaties and Governance*, 25 INT’L REV. L & ECON. 107, 113 (2005).

192. See ERIN A. O’HARA & LARRY E. RIBSTEIN, THE LAW MARKET 98 (2009).

193. Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T. 2517, 330 U.N.T.S. 3.

194. *Id.* art. 2, ¶ 1 & art. 3. For a list of current member countries, see *Status: Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958)*, UNCITRAL, http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html (last visited June 24, 2014).

195. KLAUS PETER BERGER, INTERNATIONAL ECONOMIC ARBITRATION 8 n.62 (1993) (noting that about 90% of international economic contracts have an arbitration clause); Christopher R. Drahozal & Richard W. Naimark, *Commentary*, in TOWARDS A SCIENCE OF INTERNATIONAL ARBITRATION: COLLECTED EMPIRICAL RESEARCH 57, 59 (Christopher R. Drahozal & Richard W. Naimark eds., 2005) (discussing research finding that almost 90 percent of sample of international joint venture agreements contained arbitration clauses); Alessandra Casella, *On Market Integration and the Development of Institutions: The Case of International Commercial Arbitration*, 40 EUR. ECON. REV. 155, 156 (1996); Winston Stromberg, *Avoiding the Full Court Press: International Commercial Arbitration and Other Global Alternative Dispute Resolution Processes*, 40 LOY. L.A. L. REV. 1337, 1339–40 (2007); Jane L. Volz & Roger S. Haydock, *Foreign Arbitral Award: Enforcing the Award Against the Recalcitrant Loser*, 21 WM. MITCHELL L. REV. 867, 868 (1996); William Wang, *International Arbitration: The Need for Uniform Interim Measures of Relief*, 28 BROOK. J. INT’L L. 1059, 1060 (2003); Robert K. Wrede, *Honolulu: Geneva of the Pacific?*, 7 PEPP. DISP. RESOL. L.J. 189, 193–95 (2007).

196. This Article sets aside the question of the desirability of arbitration for enforcement of bilateral investment treaties on grounds that neither its data nor its theory can effectively address the topic.

This Article's findings suggest that parties who mistrust local courts will instead resolve their disputes via arbitration. But the findings also suggest that contractual value is lost if parties cannot rely on courts to protect the value of their information and innovation. Recall that parties seemed to opt for court resolution of some claims in part to avoid having to shuffle back and forth between courts and arbitration when the claim is best enforced with injunctive relief. Although the problem could be resolved by empowering the arbitrator to grant such relief,¹⁹⁷ arbitrator authority would not extend to third parties,¹⁹⁸ and arbitrators would inevitably lack the muscle of the state in the event of violation (i.e. contempt powers). Moreover, even if arbitrators could effectively grant preliminary relief, the problems associated with third-party rights and responsibilities, bet-the-company claims, and a need for clear law and potential precedent (i.e., patent validity) could still weigh decidedly in favor of court resolution of the claim.

Especially if today's high-technology trade and development is particularly valuable to a nation,¹⁹⁹ a credible commitment to allow parties to privatize their dispute resolution will not suffice to attract maximum investment opportunities. Strong, effective courts are also needed. Other nations' courts might at least partially substitute for local courts. Thus, a policy in favor of enforcing choice-of-court clauses could also aid economic behavior. To the extent that a party's assets or conduct are local, however, local courts that can reliably grant equitable relief based on a sound legal system may remain essential to preserving the value of private contracts.²⁰⁰

China seems to recognize the need for providing effective courts for the resolution of intellectual property claims. Recall that the technology contracts between Chinese firms (many of whom claimed foreign ownership interests in the contract) opted for arbitration without any use of carve-outs at comparatively very high rates. Recently, the Chinese government has invested significant assets to develop specialized

197. The AAA has standing panels that can provide emergency relief to a party, including a preliminary injunction, but the parties must contract for the right to seek such relief, and few parties appear to use these panels.

198. This might matter, for example, in the context of noncompete clauses, where a former employer seeks to enjoin a new employer from taking advantage of the information and talents of the employee.

199. This is presumably true for most nations. *See, e.g.*, Hindman, *supra* note 185, at 469–72 (noting the importance of high-tech investments to all nations and competition for such foreign direct investment across nations); Robert M. Sherwood, *Intellectual Property in the Western Hemisphere*, 28 U. MIAMI INTER.-AM. L. REV. 565, 576–77 (1997) (discussing a study finding that IP protection in a nation has a statistically significant effect on foreign direct investment into the country “toward the creation and development of new technology”).

200. *See, e.g.*, Showmethemoney Check Cashers, Inc. v. Williams, 27 S.W.3d 361, 362 (Ark. 2000) (denying appellant's motion to arbitrate claims arising from a consumer loan agreement with carve-out for the business but not the consumer for collection claims).

intellectual property courts, despite the availability of arbitration administered by the China International Economic and Trade Arbitration Commission (CIETAC).²⁰¹ In particular, to date the government has set up about 400 intellectual property tribunals and panels across China.²⁰² However, China's struggles continue, due in large part to the extremely uneven distribution of IP cases to the new tribunals and panels.²⁰³ The busy courts have such congested dockets that they cut corners in deciding cases,²⁰⁴ while courts with very few cases are failing to provide an environment where novice judges can master the field.²⁰⁵ It will likely take a while to resolve these difficulties, and even longer before parties feel confident returning to the courts. But this very significant investment represents an acknowledgement by the Chinese government that arbitration alone will not satisfy commercial parties' demands.

Evidence of high rates of carve-outs, even in cross-border contracts, suggests that private parties would value international agreement under the Hague Choice-of-Court Convention. The Convention,²⁰⁶ concluded in 2005, would obligate member nations to honor choice-of-court agreements and enforce judgments rendered in courts chosen pursuant to party agreement.²⁰⁷ Currently, the United States is not a party to any international agreements that obligate courts to enforce court judgments rendered in other countries. Thus, parties choosing courts to resolve disputes in cross-border contracts risk not having that award enforced elsewhere. In contrast, the New York Convention obligates most nations to enforce arbitration awards rendered in other countries. To date, only Mexico has ratified the Hague Convention, although the United States and the European Union have both signed, but not yet ratified, it.²⁰⁸ The Hague Convention promises to secure cross-border enforcement of court judgments for commercial parties, which could prove particularly valuable to parties who wish to use carve-outs for some potential claims.²⁰⁹

201. Glenn R. Butterson, *Pirates, Dragons and U.S. Intellectual Property Rights in China: Problems and Prospects of Chinese Enforcement*, 38 ARIZ. L. REV. 1081, 1101 (1996).

202. Zhang Guangliang, *Discussion on IP Judicial Institution, Judges, and Ways to Hear IP Cases*, PERSP.: CHINA PATENTS & TRADEMARKS, 2011, at 80, 81.

203. *Id.*

204. *Id.* at 82.

205. *See id.* at 81.

206. Convention on Choice of Court Agreements, June 30, 2005, available at http://www.hcch.net/index_en.php?act=conventions.text&cid=98.

207. Louise Ellen Teitz, *The Hague Choice of Court Convention: Validating Party Autonomy and Providing an Alternative to Arbitration*, 53 AM. J. COMP. L. 543, 546 (2005).

208. *See Status Table: Convention of 30 June 2005 on Choice of Court Agreements*, HAGUE CONFERENCE ON PRIVATE INTERNATIONAL LAW, http://www.hcch.net/index_en.php?act=conventions.status&cid=98 (last visited June 24, 2014).

209. A caveat is in order here. We saw little evidence of contracting parties incorporating choice-of-court clauses into their carve-outs. This could be because parties contemplating a need for injunctive relief want to be able to obtain that relief wherever a contractual violation occurs.

C. Court Scrutiny of Carve-Outs

A number of U.S. state courts—most notably in California and Arkansas—consistently invalidate arbitration clauses that carve out certain types of disputes. California courts hold that arbitration clauses with carve-outs contained in employment contracts are unconscionable unless the drafting party (i.e., the business) can demonstrate a business reason for the carve-out.²¹⁰ Moreover, based on this principle, California courts have invalidated even those arbitration clauses found in CEO and other executive employment agreements,²¹¹ and have never deemed a proffered business justification sufficient to save the arbitration clause.²¹² Arkansas courts require mutuality of the obligation to arbitrate and do not accept any justification for a carve-out that benefits the business over an employee or consumer.²¹³

This Article's findings cast doubt on both of these lines of cases.²¹⁴ Carve-outs are not outlier provisions that shock the conscience. To the contrary, freely negotiated contracts—i.e., contracts between two sophisticated parties—regularly use carve-outs from arbitration clauses.²¹⁵ Moreover, courts should not automatically conclude that carve-outs found in employment contracts necessarily indicate overreaching by the employer. Indeed, CEO employment contracts involve very sophisticated employees who typically negotiate their agreements with the assistance of counsel.²¹⁶ Yet these contracts commonly use the very sorts of carve-outs that courts have held unconscionable or otherwise unenforceable. As such, this analysis suggests that the seemingly un rebuttable presumption that such carve-outs are unfair to consumers or employees is unwarranted.

Presumably some parties feel comfortable designating a court in some circumstances, if only as a permissive matter, so the Convention should nevertheless prove useful for parties relying on carve-outs.

210. *E.g.*, *Armendariz v. Found. Health Psychcare Servs., Inc.*, 6 P.3d 669, 692 (Cal. 2000); *Fitz v. NCR Corp.*, 13 Cal. Rptr. 3d 88, 103 (Cal. Ct. App. 2004).

211. *O'Hara O'Connor et al.*, *supra* note 20, at 156–57.

212. *Id.* at 155; *see, e.g.*, *Bridge Fund Capital Corp. v. Fastbucks Franchise Corp.*, 622 F.3d 996, 1005 (9th Cir. 2010) (“The only business justification offered by Fastbucks for the non-mutual judicial remedy provision was its need to seek provisional remedies, which is insufficient under California law to justify non-mutuality . . .”); *Fitz*, 13 Cal. Rptr. 3d at 105 (“NCR’s concern that arbitration may not always meet its legitimate dispute resolution needs is not a proper business justification for the exception.”); *Mercuro v. Superior Court*, 116 Cal. Rptr. 2d 671, 677–78 (Cal. Ct. App. 2002) (rejecting asserted business justification for carve-out of claims for injunctive relief).

213. *Showmethemoney Check Cashers, Inc. v. Williams*, 27 S.W.3d 361, 366–67 (Ark. 2000).

214. Conversely, this Article’s analysis supports, on a policy basis, the outcome in *THI of New Mexico at Hobbs Center, LLC v. Patton*, in which the Ninth Circuit held that the FAA preempts New Mexico’s application of unconscionability doctrine to invalidate arbitration clauses with carve-outs. 741 F.3d 1162, 1170 (10th Cir. 2014).

215. *See supra* Part II.

216. *Thomas et al.*, *supra* note 74, at 960.

Likewise, the findings belie California's requirement that the business reason justifying a carve-out be something other than the fact that arbitration is not well suited for resolving a particular type of dispute.²¹⁷ Even in contracts between sophisticated parties, that is precisely the reason parties use carve-outs. Moreover, given that these carve-outs are common across many different types of contracts where relative bargaining power and contract-drafting practices likely differ, they are unlikely to simply result from particular lawyer preferences or the dominant influence of one of the parties. No doubt, further study of carve-outs is needed before reaching any firm conclusions, but one can at least tentatively conclude that the business justification is one of significant value to the contract.²¹⁸ Specifically, even where the clause tends to benefit just one of the parties, as is the case for the CEO employment contracts, the party not benefitted by the clause, if sophisticated, agrees to its inclusion, perhaps for a price. If so, this suggests that the benefit to the party proposing the term is worth more than the cost to the other party of accepting it. In effect, the California requirement sets a standard that no business can satisfy in good faith.²¹⁹

217. See, e.g., *Armendariz v. Found. Health Psychcare Servs., Inc.*, 6 P.3d 669, 694 (Cal. 2000) (stating that a reasonable business justification must be “grounded in something other than the employer’s desire to maximize its advantage based on the perceived superiority of the judicial forum”).

218. One might think that in some contracting contexts the terms of the agreement primarily are a function of the preferences of the party that presents the terms of the initial contract draft. For example, if the buyer in an M&A deal tends to present the terms of a first draft, and the seller can only focus on some of those terms in the negotiations, then many of the buyer’s terms will never be challenged, even if they do not mutually benefit the parties. Cf. Christel Karsten & Zacharias Sautner, *What Drives the Variation in Takeover Contracts: The Economics or the Lawyers?* (Mar. 16, 2013) (working paper), available at <http://ssrn.com/abstract=2081805> (empirical study showing that terms of takeover contracts are in part a function of economic circumstance and in part a function of the drafting practices of particular law firms). Such systemic concerns clearly affect our franchise contracts, but we have no reason to believe that the technology contracts, the joint venture agreements, or the CEO employment contracts analyzed were similarly affected.

219. Even assuming there is no business reason that justifies the use of a carve-out, the state law restrictions on their use may make consumers and employees worse off rather than better off. Drahozal has shown previously that a requirement of mutuality may lead businesses to use mutual dispute resolution clauses when a non-mutual clause would make the consumer or employee better off. Drahozal, *supra* note 21, at 555–61.

The use of class waivers in arbitration clauses has analogous implications. Businesses may use an arbitration clause with a class arbitration waiver to reduce if not avoid class relief altogether. But avoiding class actions in that way involves more than simply waiving class relief. It also brings with it the other characteristics of the arbitration procedural bundle, which the parties may or may not otherwise prefer. (This point is consistent with the argument in Christopher R. Drahozal & Peter B. Rutledge, *Arbitration Clauses in Credit Card Agreements: An Empirical Analysis*, 9 J. EMPIRICAL LEGAL STUD. 536, 566 (2012), that not all businesses are likely to begin using arbitration clauses after *AT&T Mobility LLC v. Concepcion*.) As such, the use of arbitration clauses as class action waivers may impose costs on the parties entirely separate from any costs (or benefits) of the elimination of class relief. The use of carve-outs may mitigate those costs by permitting parties to

The issue of the enforceability of such carve-outs has also plagued the courts of other nations. Some nations' courts, including those in England and Hong Kong, have expressed a willingness to enforce jurisdictional clauses even when they provide asymmetric rights to one party over the other to use courts or arbitration.²²⁰ Others, however, have struck down such provisions as unfairly unequal.²²¹ This Article's analysis suggests that a categorical exclusion of forum provisions that provide unequal rights sweeps too broadly.

Consider, for example, a recent case decided in the Russian courts. In *CJSC Russian Telephone Co. v. Sony Ericsson Mobile Communications Rus LLC*, two companies agreed to arbitrate their claims, but the service provider reserved a right to bring claims to court based on monies owed to it by the other party. The court struck the clause as unfairly unequal, even though the case involved sophisticated parties who had chosen to resolve a particular claim in courts rather than in arbitration.²²² As indicated earlier, however, sound business practice can justify the clause; it does not necessarily originate from overreaching by a party. Thus, as with unconscionability in U.S. courts, a more nuanced analysis of similar foreign-law doctrines such as "mutuality" and "inequality" seems warranted.²²³

D. Severability Doctrines

This Article's findings also have implications for how courts apply severability doctrines. When a court decides it cannot refer a particular matter to arbitration, at least as contemplated by the contract, the court can

obtain the court bundle of procedures for some claims or remedies, but not if state law effectively invalidates the use of such carve-outs.

220. See, e.g., *Mauritius Commercial Bank Ltd. v. Hestia Holdings Ltd.*, [2013] EWHC (Comm) 1328 [42] (U.K.); *China Merchs. Heavy Indus. Co. v. JGC Corp.*, [2001] H.K.L.R.D. 21 (C.A.) (H.K.).

221. *Russian Tel. Co. CJSC v. Sony Ericsson Mobile Comm'ns Rus LLC*, Case No. 1831/12 (June 19, 2012), available at http://www.arbitrations.ru/userfiles/file/Case%20Law/Enforcement/Sony_Ericsson_Russian_Telephone_Company_Supreme_Court%20eng.pdf (ruling a contractual provision invalid because it gave Sony a unilateral right to bring monies owed claims to court even though all other claims by the parties were to be resolved in arbitration); see also *Cour de cassation [Cass.] [supreme court for judicial matters]*, 1e civ., Sept. 26, 2012, Bull. civ. I No. 11-26022 (Fr.) (ruling a clause in a bank account agreement invalid because it forced the consumer to arbitrate in the courts of Luxembourg but giving the bank the option to choose a different court).

222. For a recent discussion of this and related cases, see Maxi Scherer & Sophia Lange, *The French Rothschild Case: A Threat for Unilateral Dispute Resolution Clauses?*, KLUWER ARB. BLOG (July 18, 2013), <http://kluwerarbitrationblog.com/blog/2013/07/18/the-french-rothschild-case-a-threat-for-unilateral-dispute-resolution-clauses/>.

223. It could be that unbundling claims could have troublesome third-party effects by, for example, making it less costly for parties to seek arbitration in order to keep some disputes private. The claim here is not that carve-outs are *per se* desirable; rather, they are not *per se* undesirable as a policy matter.

either strike the entire arbitration clause or remove the offending portion from the scope of the clause. Our findings caution against striking the entire arbitration clause in circumstances where the problem can be resolved by severing individual claims, subject of course to the possible differences resulting from the settings in which courts are considering severability. This Section discusses severability as it arises under the unconscionability doctrine and federal statutes addressing nonarbitrability.

1. Unconscionability

When a court finds that an arbitration agreement is unconscionable, it has discretion to either strike the entire agreement or modify it to excise the offending portion. Courts typically consider whether the unconscionability infects the entire clause or just a portion of it. For example, when courts deem arbitration clauses to be unconscionable because they contain carve-outs, they often conclude that the carve-outs create nonmutual obligations that infect the entire arbitration agreement. As a result, instead of striking the carve-out, courts strike the entire arbitration agreement, which typically enables the employee or consumer to proceed with the case in court.

In some cases, an arbitration clause contains multiple problems that lead a court to strike the entire clause. In other cases, however, the difficulty is more isolated. Even in those cases, though, the entire arbitration clause sometimes is in jeopardy. A court will not strike or rewrite a portion of the arbitration agreement if the clause, as modified by the court, produces results that never would have garnered the parties' assent. Sometimes a court will strike an entire arbitration clause simply because it wishes to avoid the problem of rewriting the parties' agreement.

The findings reported here suggest that courts should be less hesitant to modify, rather than invalidate, an arbitration clause when the modification removes particular claims from the scope of the arbitration agreement. The analysis indicates that parties commonly carve-out claims from arbitration when those claims seem ill-suited for arbitration and the specification costs are sufficiently small. Thus, modification by courts on similar grounds might not interfere with the assent required for the enforcement of arbitration clauses.²²⁴

2. Statutory Nonarbitrability Provisions

Consider, also, the structure of statutes that make specified claims nonarbitrable—that is, statutes that preclude arbitration of a statutory claim under a pre-dispute arbitration clause. For example, in the Dodd-Frank

224. By comparison, invalidating the entire clause puts the parties in the position of attempting to renegotiate post-dispute an agreement entered into pre-dispute (i.e., when there was uncertainty over whether a dispute would ever arise). As discussed earlier, *see supra* note 18, the parties might come to a different agreement (or no agreement at all) after a dispute has arisen than they would have beforehand.

Wall Street Reform and Consumer Protection Act, Congress enacted a series of such provisions that preclude arbitration of whistleblower claims by employees of consumer financial services firms, commodities firms, and publicly-traded firms.²²⁵ The provisions are similar in that they limit arbitration under pre-dispute arbitration agreements and the claims at issue protect whistleblowers. But they differ in the scope of their effect. Two of the provisions invalidate the entire arbitration clause. These provisions state that the arbitration agreement is unenforceable “if the [arbitration clause] requires arbitration of a dispute arising under this section.”²²⁶ The other provision does not invalidate the entire arbitration clause. It only carves out the statutory claim from arbitration. This provision states that the arbitration agreement is unenforceable “to the extent that it requires arbitration of a dispute arising under this section.”²²⁷

A similar issue has arisen as to claims under the Magnuson-Moss Warranty Act (MMWA). The MMWA permits a warrantor of consumer goods to establish a nonbinding dispute resolution process, but does not expressly preclude the use of a binding arbitration clause. Most courts have held that claims under the MMWA are arbitrable.²²⁸ But of the courts that have held MMWA claims not arbitrable, some invalidate the entire arbitration clause,²²⁹ while others only carve out the MMWA claim from arbitration.²³⁰

By comparison, the Supreme Court has flatly held that a court must compel arbitration of pendent state-law claims, even when the court will be adjudicating a nonarbitrable federal statutory claim.²³¹ In other words, when Congress does not address the issue, a nonarbitrable claim invalidates the arbitration agreement only to the extent the agreement provides for arbitration of the claim. The Court in *Byrd* rejected the “intertwining” doctrine under which some courts, in the interests of

225. 7 U.S.C. § 26(n)(2) (2012) (“No predispute arbitration agreement shall be valid or enforceable, if the agreement requires arbitration of a dispute arising under this section.”); 12 U.S.C. § 5567(d)(2) (2012) (“[N]o predispute arbitration agreement shall be valid or enforceable to the extent that it requires arbitration of a dispute arising under this section.”); 18 U.S.C. § 1514A(e) (2012) (“No predispute arbitration agreement shall be valid or enforceable, if the agreement requires arbitration of a dispute arising under this section.”).

226. 7 U.S.C. § 26(n) (emphasis added) (commodities whistleblowers); 18 U.S.C. § 1514A(e) (emphasis added) (whistleblowers in publicly traded companies).

227. 12 U.S.C. § 5567(d)(2) (emphasis added) (whistleblowers in consumer financial services industry).

228. See, e.g., *Davis v. S. Energy Homes, Inc.*, 305 F.3d 1268, 1280 (11th Cir. 2002); *Walton v. Rose Mobile Homes LLC*, 298 F.3d 470, 479 (5th Cir. 2002); *In re Am. Homestar, Inc.*, 50 S.W.3d 480, 492 (Tex. 2001).

229. See, e.g., *Parkerson v. Smith*, 817 So. 2d 529, 534 (Miss. 2002).

230. See, e.g., *Koons Ford, Inc. v. Lobach*, 919 A.2d 722, 736–37 (Md. 2007).

231. See *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 223–24 (1985).

efficiency, had refused to send the pendent claims to arbitration when they were “intertwined” with the nonarbitrable claims.²³² The Court explained:

We therefore are not persuaded by the argument that the conflict between two goals of the Arbitration Act—enforcement of private agreements and encouragement of efficient and speedy dispute resolution—must be resolved in favor of the latter in order to realize the intent of the drafters [of the FAA]. The preeminent concern of Congress in passing the Act was to enforce private agreements into which parties had entered, and that concern requires that we rigorously enforce agreements to arbitrate, even if the result is “piecemeal” litigation, at least absent a countervailing policy manifested in another federal statute.²³³

The Court also rejected the argument that the possible preclusive effect of the arbitral proceedings (another form of bifurcation cost²³⁴) justified the intertwining doctrine:

[I]t is far from certain that arbitration proceedings will have any preclusive effect on the litigation of nonarbitrable federal claims. . . .

. . . .

The question of what preclusive effect, if any, the arbitration proceedings might have is not yet before us, however, and we do not [yet] decide it Suffice it to say that in framing preclusion rules in this context, courts shall take into account the federal interests warranting protection. As a result, there is no reason to require that district courts decline to compel arbitration, or manipulate the ordering of the resulting bifurcated proceedings, simply to avoid an infringement of federal interests.²³⁵

Our findings support the Court's decision in *Byrd*, and suggest that, if Congress desires to make a particular statutory claim nonarbitrable, it should invalidate an arbitration clause only to the extent that it covers the nonarbitrable claim. Sophisticated parties commonly are willing to bear the costs of cases bifurcated between court and arbitration to obtain the relative advantages of those two forums. As the Court concludes in *Byrd*, enforcing the parties' arbitration agreement should take precedence over concerns about “piecemeal” litigation, especially when parties themselves contract for bifurcation. Congress likewise should take this empirical

232. *Id.* at 216, 219 (describing intertwining doctrine as based on the view that the FAA's “goal of speedy and efficient decision-making is thwarted by bifurcated proceedings”).

233. *Id.* at 221.

234. *See supra* notes 51–52.

235. *Byrd*, 470 U.S. at 222–23.

reality into account when formulating statutory nonarbitrability provisions. If the parties view the costs of bifurcation as excessive, they can address the issue in their arbitration clause.

CONCLUSION

Procedural unbundling is alive and well, but not in the forms typically assumed by scholars. In a wide variety of contracts, parties routinely unbundle the procedures governing their anticipated disputes, deciding to pursue some claims and remedies in court and others in arbitration. By unbundling claims and remedies in this manner, parties can obtain greater performance incentives and lower dispute resolution costs without facing the prospect of prohibitively expensive specification costs. These latter costs are minimized, relative to the alternative of individually unbundling procedures to be applied to all possible claims, because carve-outs and carve-ins enable parties to separate governing procedures based on the nature of the specific risks of nonperformance. For most parties, less perfectly crafted off-the-rack rules applied on the basis of carefully tailored claims appear preferable to more carefully tailored procedural rules that must then apply to all possible disputes.

The prevalence of unbundling by carve-outs in contracts involving sophisticated parties has policy implications for courts' treatment of unconscionability and nonarbitrability questions that arise in the context of enforcing arbitration clauses. It also suggests that governments wishing to ensure that local courts provide value to commercial parties should focus on the substantive rules and procedures applied to claims that function to protect information, innovation, reputation, and property.